THE BROOKINGS INSTITUTION

RECENT FINANCIAL MARKET DISRUPTIONS:

IMPLICATIONS FOR THE ECONOMY AND AMERICAN FAMILIES

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UNCORRECTED TRANSCRIPT

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P R O C E E D I N G S

MR. RUBIN: The Hamilton Project began its work with a paper setting out our views as to an economic strategy for the country to promote growth, broad based participation in growth, and greater economic security.

Since then we've had a succession of events with each consisting presentation by well respect policy analysts or academics around a particular issue, such as health care coverage, health care cost, education, and tax policy, and then after that, a general panel discussing the same issue.

The papers were all done with rigorous academic review and often presented alternative approaches to the same issue. Today's event is different. We felt that the ongoing financial disruptions with the effects that those are having on far too many American families presented serious policy issues, both to the immediate future and for the longer term, and the decisions on those issues were to occur much more rapidly than we could address with our usual rigorous policy processes.

We also felt that the Hamilton Project Advisory Board, with its extraordinary combination of policy analysts, academics, and financial market participants, was especially well equipped to contribute to the consideration of policy issues raised by these disruptions. As a consequence of all of that, we decided to deviate from our usual mode and to present today's panel. The current market disruptions pose at least the following questions for our panel; one, what are the causes of these disruptions; two, what is the likelihood of these disruptions continuing or even spreading; what is the likelihood that these disruptions will leave a serious adverse impact on our economy; four, what policy actions should be taken to limit the risk of serious adverse economic impact or to help reduce foreclosures among subprime mortgagors; five, do these disruptions bring to light any shortcomings in our regulatory system with respect to financial markets or consumer protection that should be addressed with additional measures.

With that, let me make a few brief observations with respect to these questions. Market based financial systems contribute enormously to the economic well being of our economy. But they have histories of seemingly inevitable periodic excess leading to periodic disruption.

The objective of regulatory policy, in my view, ought not to be to eliminate or even to minimize risk, but rather to find the optimal balance between allowing, on the one hand, the benefits of the free operation markets, and on the other hand, limiting systemic risk to regulatory constraint.

The current disruptions are the product of a greater and greater underweighting of risk across almost all active classes during recent years. This included, very importantly, the terms and pricing of credit extension, especially in subprime mortgages and in private equity finance. Let me just say as a side that with respect to the stock market, because of the general interest, price earnings valuation ratios have been within stock norms, but these ratios replied to total earnings that were 20 to 25 percent higher as a percentage of the economy than the average of the last 40 years and 50 percent higher than the average of the 1990's.

In recent years, many people felt liquidity would sustain an environment of low risk weightings for a long, long time. My own view is that liquidity is not primarily a monetary phenomenon, but rather a psychological phenomenon.

Thus, when the psychology changes, creditors and investors withdraw from riskier assets, reduce leverage, reduce exposure, and then as the prices fall and credit tightens, and commentators say the liquidity has shrunk.

Turn to the immediate economic outlook; it seems to me to be highly uncertain with a reasonable chance of either a soft landing or serious difficulty. In this context, there are many issues for our panel to consider. These include the probability or the probabilities of various possible economic outcomes, how best to limit economic difficulty, and how to reduce the large increase in foreclosures to lower income families that is such a terrible hardship for those families. The discussion of all of this could include the actions of the Federal Reserve Board, possible roles for Fannie Mae and Freddie Mac, limiting moral hazard for lenders and possibly for borrowers, and greatly increase assistance for subprime mortgagors in negotiating with lenders.

Several community development professionals told me the other day that help with renegotiation could be the single most effective measure to help subprime borrowers, but that it is very difficult to set up that type of capability because of the difficulty of finding adequately equipped staff.

As to mortgagor issues, my own view is that financial engineering, including derivatives of securitization, as well as hedge funds and private equity funds, contribute meaningfully to our economy.

For example, financial engineering can help business and investors manage risk in far more effective ways. Companies that are taking private can operate against long term strategies rather than have to react to the short term pressures -- Companies who are taking private can also avoid many of the cost and managerial distractions of being public.

Having said all that, all of those activities have the potential for increasing systemic risk under at least some circumstances. And that has raised the question of whether additional regulatory measures would unbalance the constructive in any of these areas. One view that, in my judgment, should be given serious consideration is that capital and margin requirements around financial engineering should be significantly enhanced in order to reduce risk exposure. On the other hand, specific private equity and -- regulation seem to me unlikely to be productive, so that is certainly a matter for debate.

There are also important questions being raised about regulatory measures in the mortgage area with respect to sales practices, prohibition of certain mortgage provisions, enforcement, and the federal role versus the state role.

With these two observations on what is truly a vast subject, I enormously look forward to the deliberations of our panel. As I said a moment ago, it is extraordinarily well equipped to explore the many complex and important questions raised by the current market disruption.

Before introducing our participants, let me thank the Hamilton Project Team, and most especially Jason Furman, Karen Anderson, and Leandra English for putting this event together. Let me now briefly introduce our outstanding group of panelists; they are Roger Altman, Chief Executive Officer of Evercore, New York based investment banking firm, former Deputy Secretary of the Treasury; Doug Elmendorf, Senior Fellow at Brookings and formerly worked at the Treasury, the Federal Reserve Board, the Congressional Budget Office, and the Council of Economic Advisors; Doug wasn't able to hold a job; Eric Mindich, Chief Executive Officer of Eton Park, a New York based hedge fund, former partner of Goldman Sachs and Company. Earlier this week, Eric was also named the Chair, the Assets Manager Committee established by the President's Working Group on Financial Markets. Bob Steel, Under Secretary of the Treasury for Domestic Policy and former partner of Goldman Sachs and Company; and Larry Summers, Charles W.

Elliott University Professor at Harvard University, advisor to the D.E. Shaw Group, New York City, former Secretary of the Treasury, former President of Harvard University.

The Moderator of our panel is Jerry Seib, Washington Bureau Chief, the Wall Street Journal, distinguished columnist, and commentator on CNBC. With that, Jerry, it is all yours.

MR. SEIB: Thanks. I have, of course, the easiest job in the whole today, which I'm grateful for. I get to ask questions, I don't have to answer any of them, and all the questions on this topic are difficult, some imponderable, none of them, obviously, answerable today.

But this is an incredible group of people. To attempt to do that, Jason has assembled I think the best possible group of people. And -- a blank sheet of paper, this is pretty much the group that you would want talking about these topics, so I appreciate that. As a layman and an outsider watching the subprime credit market problems of the last month or six weeks unfold, what struck me is, I keep wondering how did so many people who are obviously so smart either not see it coming or get it wrong, which is actually one of the broad issues I hope we can address here today.

What I will encourage the panelists to do and hereby request that you do is, interrupt each other, argue with each other, make my job easier by asking each other questions, I encourage all of that.

And to you in the audience, I will just let you know, we're going to talk for a while, for an hour or so, here, and then we will open it up for questions at the end, and there will be a mike running around, so I look forward to that, as well.

It seems the best place to start today is with Bob, to talk about the Bush Administration, which is clearly on the front line in this problem, and probably can get us best started by talking a little bit about the Administration's view of the problem, the subprime, the prices, the credit market issues that have arisen out of that, why this wasn't seen earlier, and what the strategy is for moving forward from here. And so, Bob, let's just start with that, and if you could address that a bit, then we'll go from there.

MR. STEEL: Perfect, great. Thank you, Jerry. And I can tell you, I very much appreciate the opportunity to be here and talk about these important issues and share with you some of the ways in which the Administration is thinking about these things. Having said that, I think we'll also, the Administration, that is, be a beneficiary of hearing the different perspectives. I think we've tried to say all along that we don't have all the answers and we're interested in hearing other peoples' perspectives on how things should unfold.

The Hamilton Project has become an important force in a short period of time with forums and conferences that are attracting lots of attention, and so it's good for us to be here. I think the way in terms of framing, which is what you suggested, the way I think about it is that over the last several years, we've had favorable economic conditions, low unemployment, good growth, low inflation, low interest rates, and so there developed a confidence among investors where investors were interested in participating and so pursued investments in all kinds of assets.

The result of that is that asset prices rose, over terms declined as the prices rose, and as a result, so as to maintain their returns, people chose either purposefully more risky assets or they chose to own assets that they previously owned with additional leverage so as to keep their returns at the level at which they were enjoying. And Larry recently wrote about this and gave examples of this happening historically. And to be honest, this is a movie that we've seen before. But I think it unfolded in a way that's been the way these things tend to develop. It was especially true, as you highlight, in the mortgage area. And I think that now is the time to push pause. You mentioned people not getting it right. Well, there was one person that wrote about this, and if people haven't read the book that Ed Gramlich wrote this spring and read about his perspective on the mortgage market and about what was developing subprime, then that should be required reading for somebody that wants to understand this.

So some people did write about this. And in Ed's book, he lays the foundation for how this developed. And I think if you look back, that we had a very successful mortgage industry that was the marvel of the world in terms of creating home ownership opportunity for lots of people.

But really, I think that as Ed described, that there developed excess capacity in what I think of as the mortgage production business, and so as one would expect, those people who were interested in producing mortgages lowered their standards and broadened the approach they took to the production of mortgages, and so we produced new mortgages that were of a lower quality and had more risk, and for lots of reasons, either because people had blinders on and didn't want to see, or because there were some systemic characteristics that didn't make this clear that the production of mortgages were sharing more risk. I agree with Bob that securitization and these financial innovations have, in general, generated lots of very exciting ways in which people can organize investing and organize in capital their capital structure, and so this was an example of that, but it's raised lots of questions as mortgage rates begin to rise, and now we live, as you would expect, the least attractive mortgages will produce the last part of this cycle, and so we're going to work through those, and now we have the resets facing us now.

So that's what happened, I believe, in terms of framing things, and maybe some of the panelists will see it differently and I'll benefit from their perspective. So then you basically get to the issue of what do we do? And I think of this in three lanes, Jerry, that first is the issue with regard to the financial markets and the response by the Federal Reserve.

And basically, Chairman Bernanke has -- in the Fed has responded, and you saw what they did, and so that action will play out, and that's really the responsibility of the Fed. Now what really gets the Administration which I think is on the issue of these large number of homeowners, this is the second key issue, and what we can do to help as many as can possibly be in their home stay in their home, and now is a time for the thumb of government to go on the scale to be helpful to these people. And in the Administration, we've talked about several different things that we want to do. I think that the first thing is to realize that when you study this issue, one of the real challenges is, lots of people have the ability to stay in their home, but when this impending challenge comes at them, they freeze, they don't contact their lender, they don't ask for help. An amazing number percentage, some estimate as high as 50 percent of the people who go into foreclosure never called their lender and said, I'm facing a problem, could you work with me. And so if you look at it as a production process, the way we think about it is, you have the servicers now who, because of securitization, are a key player, then you basically have the counselor that Bob alluded to, and then you have the lending products.

And we need to encourage early identification, which is part of the responsibility of servicer, of people that are facing resets, then we need to get them plugged in with the counselors, the independent counselors, people like -- is a terrific example that we've worked with, to basically work with them with the servicer and their lender directly on some occasions, where it can be, we need to encourage the servicers to accept the maximum amount of flexibility, and you know, the banking regulators provided a perspective just a month or two ago encouraging the servicers to be flexible with regard to this issue. And it's complicated, the contractual issues. But I think that the regulators encourage flexibility, and that's key, and then getting this process working with early identification, good independent counseling, and new products where lots of people can help. The FHA can help, Fannie and Freddie can help, and private lenders can help. And so that's the process we're working through.

There are a couple of other specifics. We suggested that Congress -- and it was suggested that Congress take up a tax adjustment. As you know, if you basically adjust your mortgage, then that event can generate income and taxes. We suggested that for a short period of time, that the forgiveness of debt with regard to a home mortgage should be exempt from taxes and not part of income, so that that reduces a speed bump in this process, and so that seems like a good policy aspect to us.

We've been strong advocates for FHA modernization, and we think that's a good thing to do. FHA can do a lot to help, and there's a bill which has passed the House and now moving forward, we hope, with regard to modernization.

I guess if -- I don't want to go on because it's something we think about a lot. Let me just conclude by our response really is that we should basically find ways, as I said, to put a thumb on the scale for the benefit of the individual owner occupied single family home, so that those people who -- there is a solution to this can figure it out, and we should help them, we should not help -- we should not view this as a bail out of investors, of speculators, et cetera, but instead, going on the scale for those people, they'll still be foreclosures, but that's the way that we should think about it.

Just the last point of what we should do; number one is the Fed, number two is the Administration, and number three is going forward what should we learn, because as we work through this, I think that the President's Working Group was tasked by the President to focus on, as Bob suggested, issues like securitization, issues like ratings agencies, issues like mortgage origination standards are something we should look at and try to learn from a situation and make them better going forward, but be careful not to go too far so as to effect the availability of credit to people that might not have perfect credit scores, so that they can get -- there are lots of good things, as the Ed Gramlich book talked about, of people who get on that first rung and can move ahead. So maybe if I stop there, I'm sorry if that was a bit long.

MR. SEIB: No, that's great, thanks. Let's stretch out from there. Larry, can I turn to you? If you were the policy God, what would you do differently?

MR. SUMMERS: What do you want?

MR. SEIB: Well, we'll find out. What would you advocate for doing that the Administration hasn't done, where might you do more, where might you do less, what might you do differently?

MR. SUMMERS: You know, if I had responsibility, I'd be spending 16 hours a day acquainting myself with all the facts in a way that I haven't, so I'm very reluctant to make prescription -- make strongly differential prescriptions.

But I would make a couple of comments that I think go to thinking about this problem clearly. One is, I would agree very much with Bob on the quality of Ed Gramlich's analysis. And I would highlight one very important conclusion of his analysis and a broader implication of it.

The fraction of African Americans in America who owned a home a decade ago was close to 40 percent; a fraction who owns their home today is above 50 percent, and that is hugely related to subprime lending.

We need to ask ourselves the question, and I don't think the question has been put in a direct way and people have developed an answer; what is the optimal rate of foreclosures? How much are we prepared to accept?

Suppose somebody wants to take a home, and somebody wants to lend the money, and you don't know what's going to happen, and there's a 15 percent chance they'll get foreclosed over the succeeding four years; is that a loan that should be the objective of public policy to prevent happening? Is that a loan that should be the objective of public policy to encourage happening? I think we need some clear thinking on what would constitute a desirable state. What I think is very clear is that there are a lot of people who have been misled into homes, who haven't understood what they were getting into, who weren't told what they were getting into.

And I think it's clear that when you vest regulation for consumer protection with agencies like the Federal Reserve whose primary mandate is the health of the financial system and the health of the lenders, you are going to get insufficient vigilance with respect to consumer protection.

So I think we have a process problem around what is misleading. But we don't have -- but it is less clear just what kind of standards we want to achieve. Similarly, I think there's a shared assumption here that is right to some degree, but is not completely right, and that is, is the primary objective of public policy right now to reduce as close to zero as possible the number of foreclosures that take place now that we are in this situation.

Listening to much of the discussion, you could suppose that that was the objective. And I think it's very important to emphasize that there are some people who in almost no credible scenario are going to be able to continue to make the payments that go with the value of the home that they own. You are probably doing them no favor, and in many ways repeating the error that got us into this situation if you seek to make up some scheme that gives them a larger payment down the road, but a shorter payment now, and let's them stay in the home.

So I think the crucial task of policy is not to minimize the number of foreclosures, but it is to find the best ways of distinguishing between those who credibly can stay in their homes and should and are suffering from a confidence problem and those who, for whatever reason, are in a non-viable situation, and getting them out of that situation and giving them some transitional assistance when it takes place.

I think there is an oddity, and I understand why it is done, but I think there is an oddity in the Administration's emphasis on changing the tax treatment of loan forgiveness. If you are in the lower half of American families, you're really not paying any income taxes, and those loan forgiveness provisions are going to do you very little good.

On the other hand, you're really going to have a huge burden when you are foreclosed. So I would hope we would have perhaps a refundable provision around the loan forgiveness, or perhaps more viably an expenditure program, the kind that Ed Glazer has proposed in the Massachusetts context, that would provide transitional assistance for those who are being foreclosed. I think there is a real danger that we are going to lurch into a kind of Japanese style solution of, at all costs, let's roll over all the loans and not inflict any -- not inflict any distress in order to maintain confidence. And I would hope that those with proposals in this area would be very attentive to the question of how their schemes are going to sharply -- are going to distinguish as best one can those for whom it's a liquidity problem and those for whom it's a fundamental insolvency problem.

Finally, and we can come back to this if you'd like, Jerry, I think there is a strong, even a compelling case, in my view, for at least a short rung increase in the conforming loan limit of the GSE's and for a parallel adjustment in the current constraints with respect to what kinds of subprime or risky loans would conform.

I think that case is an order of magnitude stronger than the case for increasing the GSE's balance sheet, which would mostly serve to enable them to buy more conforming mortgages where there is not a major credit problem.

And while Chairman Bernanke has made that point in a letter, I think there has been a tendency for all the GSE issues to be inflated together.

MR. SEIB: That's a good point. We want to get -- do you want to go to GSE's and credit rating agencies. Let's put those on hold for just a second and turn to Doug with one last broader question before we begin. Doug has just written, for those of you who haven't seen it, a really marvelous paper that -- I think you can get it on the Brookings web site, that is --

MR. ELMENDORF: Stacked outside.

MR. SEIB: -- stacked outside, better yet. It's a wonderful summary of the issues, the questions, and some of the answers, not all, obviously, but it's the best summary I've seen. What Bob has said and what Larry has said raised a broader question in my mind, which is, if you put your thumb on the scale, to use Bob's phrase at this point, as the government, is the greater danger at this point that the government does too much and overreacts or not enough and underreacts. And I think -- I have the sense we're sort of right at the edge of that question and it could go either way. Having thought about this a lot for the paper you just wrote, where do you -- where is the word greater in your mind?

MR. ELMENDORF: Well, I think there are possible errors on both sides relative to the position the Administration has taken. I personally am moved in the direction of providing more support for households that are being foreclosed upon. I agree strongly with Larry's view and with Bob's view that there is a down thing here, that when we consider which households to help, you need to balance the government's role as a protector of people in vulnerable positions, with the responsibility of people in our free market economy that bear the consequences of the decisions they've made. And I agree also it does no favor to see people in houses that they are not plausibly close to being able to pay for.

At the same time, though, I think the Administration's current proposal for the Federal Housing Administration, the FHA, I think are wonderful steps in the right direction, but I would go further. Under those proposals, the FHA essentially helps people to refinance their mortgages, but only to the point at which people can pay insurance premium for the risk of their mortgages.

And I think one way to identify the people who can stay in their homes with a little more help would be to put some federal money, additional federal money, into the FHA, and to use that to help pay for the premium on this mortgage insurance that households normally pay for through the FHA.

And by calibrating the amount of that federal subsidy to those premiums, we can help more households, and several hundred thousand would be helped under the Administration's plan, while also ensuring that we're not going so far as to temporarily paper over other households and keep them in situations that they can't afford. So I think by putting more money into the FHA, one can shift a little bit in the direction of helping more households and helping those that are closer to the cost of being able to stay in their home.

MR. SEIB: Thanks; there are a couple of questions that have been laid on the table that sort of -- already that are in the broad category of how did we get here and I've been wanting to ask you about one of those.

The performance of the rating agency is very much on the minds of people as they think about how do we dissect the problem. Let me ask you to talk a little bit about that. Do you think they got it wrong, do you think something ought to be done, the rating agency, should the government do something at this point, or is there another approach to that question?

MR. SUMMERS: Jerry, let me make two basic points, one of which relates to your question and one of which in a broad sense relates to it, but it gets right to the core of it. This issue of how we got here, my own view is that what we've seen is a correction in the wake of a pretty classic bubble, and that such bubbles occur periodically, you saw one on the equity side with the NASDAQ boom and the dotcom boom and so forth and all the fallout in '98, '99, and 2000.

The biggest one I can remember was in Japan in the mid '80's and late '80's, with the stock price and real estate boom -- remember getting about 39,000, it's currently about 15,000, and it's never seen half of 39,000 ever since. So these occur from time to time. And what happened here I think is just classic or fundamental, whatever term you like. Interest rates were very low by historical standards, and Chairman Bernanke and others have talked about a global savings squad, and -- as a primary driver of that, and I don't have any quarrel with his construct.

And when interest rates get that low, lenders, of course, strive for incremental yield, because it's very hard to find it. If they're low long enough, they ease the normal standards that they use in terms of the types of credits they'll accept and then ultimately it effects the term that they'll live with on those credits.

And you have the type of speculative excess at this time on the credit side that you've seen before in other context. It's essentially a pretty natural process, the psychology of markets, which, in my experience, overshoot -- typically overshoot both from the up side and the down side.

And so how we got here, to me, is -- the very short answer is, we got here because this is how markets very often operate. And the core of the problem, to me, is the mortgage side of it, particularly subprime, and the question that flows from that is how we address that.

But I think there's a lot of talk about how we got here as if there was a gigantic failure, and with the exception of a lot of fraudulent like behavior in the mortgage market, especially at the mortgage broker level, I think a lot of this was the natural excess in markets, and that we will see it again, and in the very, very long run, it's essentially healthy. In terms of the rating agencies, I think the ratings agencies are indirectly regulated by markets.

By that I mean when they occasionally suffer the way they're now suffering, suffer credibility, then the value of their ratings is diminished, and the value that investors place on them and other market participants place on them is diminished.

Incidentally, Moody's, which is the best known of the rating agencies, which is publicly owned, has seen its shares fall quite sharply since all this happened, so there have been big losses there, and obviously a lot of pressure on the board and the management and so forth.

So the rating agencies can't simply sit there when they suffer blows like this. They have to correct it, correct these mistakes, and that's because they can't afford a situation where their ratings are of less value than usual. If they ever got to a point where people didn't care about their ratings, they'd have no business.

So should we regulate the rating agencies? And the big sense of that term, mind you, is no. Are there some possible adjustments like Arthur Levett has suggested which might, for example, separate the rating agency functions from the structure finance functions? I'm not smart enough to know the answer to those, those are good questions he's raised and ought to be evaluated. But in the big broad sense, should the rating agency be federally regulated? No.

Eric, let me turn you, Roger, in a way, addressed a big question and a small question. The big question is, how did we get here, you're in the hedge fund world, should it have -- should people in your world have seen this coming, could it have been more predictable, should it have been predicted better, and in the narrow sense, how badly served were people in the markets by the credit rating agencies along the way, and should something be done about that different from what Roger suggested?

MR. MINDICH: Sure, thank you. I would say a number of people --

lots of people saw it coming, most people didn't necessarily act on what they saw coming. I'm a big believer in Noah's Law, which is -- which says that you get rewarded not for predicting rain, but for building the arc. There are lots of people predicting rain, but not a lot of people building arcs, and that's one of the insidious things about how markets, you know, can develop and go to the excess that Roger described.

You know, I think fundamentally how we got here is similar to what Roger said, but with some important differences I think. I think fundamentally what happened is that the bad price signal that came to the market from the cheap and easy credit that was around for so long, I think actually infected lots of decisions of the micro economy, far beyond just, you know, just the pricing and credit. I think we, you know, are just in the early stages of finding out what exactly those were.

You know, the rise in structured finance and the mathematical model that came with it -- a lot of really good things about it. One of the interesting consequences is that it takes previously owned correlated assets and makes them correlated precisely because they had been historically uncorrelated, and therefore, they get put into jumbles of things with, you know, good characteristics, and you created a connection precisely because there wasn't one before.

And I think that the credit markets are fundamentally -- are really increasing by securitization, it's because banks are increasingly moving business --

storage business for lots of good reason for -- and that securitization model is fundamentally driven by the confidence in those ratings.

And I think that, you know, that those ratings have been -- their confidence has been severely, severely damaged, and again, so much that you can't just take, you know, movies plus five, you know, these are just so often so wrong that you can't -- there's no north star, it's too cloudy, you don't really know how to steer the ship. And I don't think that the market can discipline the rating agencies sufficiently for a variety of reasons. They are, you know, understandably trying to, you know, protect their franchise. One reasonable way to protect their franchise is to continue to insist that they're right and in three to five years we'll find out they were, but our society can't afford to have the credit market stuck for so long because we can't, you know, because we can't have confidence in those ratings.

And so I think there's a lot more that should happen. I think that there are a number of issues and problems for the rating agencies that are difficult to fix. I think one that could be fixed is the perception, probably the reality, in part, but at least the perception that their, you know, fundamental business model has got some serious conflicts associated with it.

And in the, you know, equity research, you know, issues on Wall Street, you know, in the last -- bubble, there were lots of really smart, hard working, well intentioned people in equity research, and they were kind of doing today what they did yesterday, and then all of a sudden people said, hey, why don't we look at the different perspectives, and we did, and they said, gee, we should probably change a lot of things and go back to first principals and make those changes, and I think that it's time to do that kind of thing for the rating agencies, too. I think there's so many things that Arthur Levett has described, I think there are a number of other things that could, you know, that could happen. In one small, but recent example, there was a very large -- they had an event that happened, S&P downgraded them by one notch, Fitch downgraded them by two notches, the issuer said thank you, you're fired.

You know, to Fitch's credit, they said, well, you know, you can't fire me, you know, you can stop paying me, but you can't fire me. But the issue has to be that you can't, you know, that incentive is just so -- it's just so pernicious, you know.

So I would go back to first principals. I would have a total top down review of their business models, I might separate research, you know, kind of do consulting from the, you know, from the ratings, I would, at minimum, disclose all the contacts between those things as part of the rating process, and not just, you know, we may from time to time provide services, but to detail like an emerger proxy, it says on February 12th, Fred spoke to Sally and said this, and then they changed that, there are about five or six things along those lines I'm working with, but those are the changes I'd make.

SPEAKER: We tend very much to agree with what Eric said. And I would say that the most thoughtful eight or ten words that I've heard on this subject were from Eric some time ago, when he said Enron -- he said Enron was to accounting firms as subprime is to rating agencies, and I think it's a very powerful thought. I am very skeptical of market regulation here. And I would just put it this way, if an airline crashes a lot, nobody is going to fly it, and its stock price is going to go way down. But we don't as a society usually regard that as a sufficient basis for having confidence in airlines. And so I think we need to be careful about market regulation.

There's an aspect of all of this that actually has always puzzled me, and Bob, this is a slightly cheap shot at your Administration, I'll concede, I will concede before I --

MR. STEEL: A real cheap one.

MR. SUMMERS: -- before I deliver it. There are lots of different theories of human motivation that we -- there are lots of different theories of human motivation and human incentives and whether people respond strongly to incentives and other people don't respond as strongly to incentives. There are a lot of different views one can have.

But I am mystified by the view that the world will more or less end if the top tax rate goes from 35 to 39 percent, because everybody will be entirely demotivated. But that if you have a bunch of people who have to give grades to the people who are going to hire them and pay them money, their behavior will proceed with total integrity. This seems -- people either do respond to financial incentives or don't respond to financial incentives. And I find it close to unfathomable that if you are hired by someone at twice your regular fee to work collaboratively with their people to design a security that will receive a triple A rating from yourself for which they will pay you, that you are likely to deliver a set of results that others should regard in a highly credible way.

And so I think that there needs to be a lot of cleaning up in this area, and I think it actually points up a very general principal that I would use with respect to regulatory policy. I'm thinking about what kinds of regulation I'm for and what kinds of regulation I'm against.

If the theory of the regulation is, something bad has happened that people in the private sector didn't foresee, people in the government are smart and they should be charged with foreseeing it and making sure it doesn't happen, I think it's probably wrong and it's probably not going to work out that great as a regulation.

On the other hand, if the theory is, somebody in the private sector has an obvious conflict of interest, and because of that obvious conflict of interest, the fact that they get paid for their mortgage, whether they -- and then they sell it off to somebody else, and so all they care about is how many mortgages they've produced, the fact that they get paid for the rating, when there's an obvious conflict of interest that encourages bad behavior, then I think there's some presumption that the free market will not tend to get it right and that some kind of regulation is a good idea. So I guess I would refrain the debate slightly for more regulation versus less regulation to regulation that's based on the regulator's superior knowledge, I tend to doubt.

Regulation that's based on the market arrangement is right with what economists call principal agent problems and regular people call conflict of interest. I think there should be some positive presumption that regulation could improve the situation, all right. So --

SPEAKER: Well, I'm not -- I think those are -- the points that you and Eric made, Larry, are good ones on the rating agencies, and no one in his right mind would I think issue a bringing and forceful defense of organization as unvibrant as Moody's and -- but, Eric, let me just ask you. When you say their business model ought to be reviewed and perhaps adjusted and all that stuff, by whom?

MR. MINDICH: Well, that's a good question. You know, I think that, you know, I'm just a Wall Street guy, I don't know, you know, how everything down in the 202 area code works. But my, you know, my sense is that --

SPEAKER: In the 202 area code, we don't ever understand completely what's going on in Wall Street.

MR. MINDICH: But, you know, what I would speak of, there were -- I don't know if there was a mechanism for the federal government to do that. My guess is that the time for that to happen might take more than the market really -- this is playing out in real time.

You know, there were a lot of things not to like about the way that the -- happened on Wall Street, it was started by litigation -- but it really did need to not only some things that I think will work for the best, but -- and I think that -- I'm not saying that someone should -- whatever it is, but I think that it may take something outside the normal regulatory and legislative process and we would kind of push if you haven't.

I don't think the market is going to do it because -- really, really hard to set up a new rating agency. You know, in the insurance brokerage role, you know, people got led off in handcuffs, all sorts of stuff, and people said, gee, let's go set up a new insurance brokerage firm, and you couldn't really do it.

So I think that's part -- and I think -- and the reason why I think time is of the essence is, you know, a lot of this panel discussion has been about, you know, the subprime problem. To me, the subprime problem is just a symptom of the underlying problem with all this stuff. And I think that, you know, you shouldn't be surprised that in the early stages of an -- credit bubble, that the folks -- on their skis are the ones that topple first. But I think there's lots of good reason to think this is going to, you know, impact the commercial, you know, the kind of CNDS kind of a whole variety of other types of things that rely on. I think it should be done by whoever, you know, thinks it can do it, like really, really right away.

SPEAKER: Well, since Larry knows perhaps a little more about the 202 area code, by whom?

MR. SUMMERS: I think it's a good question, and I would hope there would be a better answer than the one I'm going to provide. But here would be the answer that I propose right now. Ratings are shot through our financial -- our system of financial regulation. They're embodied in -- two, they're embodied in a whole set of SEC regulations about what's prudent and what's not.

If the President's Working Group on financial markets were to say that for a rating to be valid, we qualify you to hold a certain security or some, you know, for you to get a zero capital charge because it's a triple A security or whatever, that triple A has to come from a rating agency that avoids these five possible conflicts of interest.

I think the lever would change quite quickly. So I think the answer is that precisely the cause, probably in more ways than we should have, we have made these rating agencies, we've given them sort of quasi-public responsibility by letting the ratings influence a whole set of regulations. Ironically, there is a kind of leverage for which a group could determine what constitute the right kind of regulations on conflict of interest and then move them forward.

SPEAKER: Well, I think that the perspective is what Larry suggests, and the President's Working Group has raised their hand and said that we're going to get at this straight away, and the work has begun. I think that we shouldn't have a conclusion as to where that work takes us until we do the work. And hopefully, as part of that work, will also lay a path as to how to proceed so as to address the issues raised, where I think that I would have a perspective -- of what Larry and Eric have suggested with regard to this is quite complicated and has lots of challenges that need to be understood.

And sometimes you look at an issue and imagine that the end might be with rating agencies being less of a part of the solution. But I think, as Larry suggested, for better or for worse, the reality is, rating agencies have a very important role, and the goal should be to set up a framework by which they can be successful and have the right agency principal dynamic, et cetera.

And the analogy that Eric gave I think to accounting firms, we just can't have confidence in our financial system without confidence in accounting. And likewise, we need confidence in rating agencies for all the same reasons.

MR. SEIB: First of all, I admire your strength in not rising to debate on the top tax rate. But Larry also put another -- there are two other big public policy questions that are on the table that I wanted to turn to here. The first one, Larry actually raised an issue which is the GSE. And the second, which we haven't touched on yet, is the Federal Reserve, and I'll turn to you next, Doug, to do that -- but talk a little bit about the GSE, what's their role, what should their role be now, what makes sense, what doesn't make sense in this environment to make a change, if any, in the way they play in this game.

MR. ELMENDORF: I should have said in my last that, you know, there are two of the seven heads of the President's Working Group here today, so it's a great difference, but I suggest -- I think that's the right group, but Bob and Larry both served in that role, and so they should get -- I should seek them out.

You know, GSE's, boy, when I took this job, I went back and read testimony and hearings, and this has been an interesting issue where there's a good track record of what people thing. And amazingly, it doesn't seem to be partisan on certain perspectives, that if you work at 1500 Pennsylvania, there is a point of view of issues that one becomes appointed with.

I think there are two or three things that people conflate, and we need to stop and pull them apart. One is the issue of the business model of GSE's, and two is what they should be doing and the mission, and three is the right regulatory regime. I think that, to be honest, we're all probably on pretty much the same page. And as Chairman Bernanke suggested in his response to Barney Frank, and then Secretary Paulson said in a letter he sent to Senator Dodd that -- and from our perspective, that the Administration is open to the issue of flexibility about the business model, consistent with comprehensive legislation that gives a strong regulator.

Today there's quite an odd construct of regulation; one regulator with mission, one regulation with safety and soundness. The regulator doesn't have the tools that a normal regulator has. And so our view is that if there needs to be some flexibility which can be constructed to the markets on a short term basis, then we should have that discussion.

Let's just remember that besides the portfolio was a safety and soundness issue, that lies with a fail. It should not and is not subject to anybody's lobbying, in my view, but that's their job. They're an independent regulator with that responsibility.

With regard to Congress, it sets the abilities for what they can do with regard to where they provide a mortgage finance. They set the conforming loan standards and that's their responsibility. We have a point of view that historically we've been quite cautious on expanding their areas of responsibility, but the Secretary has also expressed flexibility, given what's going on, on a temporary basis, consistent with overall comprehensive legislation to have a strong regulator. And I think when you pull these issues apart, that actually there's probably reasonable agreement, but Larry should speak for himself, but I think that that's -- we probably -

- and I went back and was reading just this week some of the testimony from the people that had my job when I worked for Larry. And we could borrow the same language and sing the same song.

SPEAKER: Yeah, I -- that's right. In my column where I reference this, I had a carefully chosen sentence. I said, "If there was ever a time when the GSE's should be" -- but it did have that very careful conditional flaw. And I think there is a somewhat unfortunate conflation, and I think it is very difficult to manage, and I don't want to say that you're managing it wrong.

Between the fact that two things are happening right now; one is, we're having the worse liquidity crisis around American housing in 50 years; and the other is that a long multi-year effort to clean up the regulatory structure and control the excessive government guarantees of the GSE's is coming to a conclusion. And it is a tad unfortunate that those two things are both happening at once. And it makes the problem of addressing policy towards the GSE's in a way that could be summarized in a single -- summarized in the way newspapers do, in single sound bites, extremely difficult. And I suspect that people of good will could probably come together on a package that had as its central theme more action now, more control over the medium and long term. The danger is sort of the St. Augustine, give me chastity, but not yet.

SPEAKER: Well, there's a bill that passed the House.

SPEAKER: And that invites a certain hypocrisy. I think it's a very difficult problem to manage because of those two imperatives.

SPEAKER: Well, the good news is that things have come together where there is a bill that passed the House that, from our perspective, is within the realm of working with and we'd like to make progress on it. So there's been more traction in history. As you said, this has been a long process, so hopefully that it would be quite elegant should we accomplish these things if this is the time to use that important work. Bob, anything further?

MR. STEEL: The only thing I would add is, as Larry just said, this is not the moment to do it, because the focus should be, as he just said, more in the short term. But I think over the long term, one has to step back and ask whether it gives them time for a very fundamental review of the mission of these organizations. After all, they've had very mixed histories in recent years, mixed performance, and there was a period during which they were dedicated to becoming growth stocks. I never understood that. Then there was a period during which each of the two leading agencies had a lot of scandal. And I think you have to really ask yourself whether what they are now is what they were intended to be and whether the subsidy, which is a very, very large one, which is provided to them, is truly aligned with, so to speak, their current mission. I'm a bit skeptical on that.

MR. SEIB: Before we turn to the monetary, let me just check. I think you've talked about FHA being a better place for the government -- refinancing issues and Fannie and Freddie; is that where you're coming from in this? And do you have any thoughts about --

SPEAKER: I think -- maybe I'll expand a little bit from there. First, I agree with what Larry said. I mean I think, generally speaking, it would be much better if GSE's were smaller, you know, or not nearly the, you know, you look what happened with Northern Rock and you say, God forbid, if that happened with one of these things, it would be just a colossal problem.

But it may not be the time; it may not be the time to do it. I do think that the -- I think it is important. One of the -- there are a lot of great things about securitization. One of the problems with securitization has been that from the moment that, you know, the end, you know, borrower, you know, does this loan, they do it through a mortgage broker, it gets sold on to some originator, it gets secured -- to the market, there's no significant institution that's still around in the game. And so I think that there's some logic for being FHA, or you know, or some institution like that.

I do think that if we were to make -- I think that there is a danger of some of this Japanese style thing, and I think that if we make some changes with the GSE's, that they should be -- we should intend for them to be permanent.

I think the idea of raising the cap we're doing for six months or whatever, I think that's a very dangerous game. You know, you want the market to change its expectation for that or not, but I think doing it for a temporary time period is harder.

I think thing that I probably would do is to try to find some way to link the mortgage brokers more tightly into financial institutions. So an example would be, without creating more regulation of those mortgage brokers, you could say if a mortgage broker sold more than X, per se, and more than half of their production to a financial institution and then secure ties it, that they were an agent of that financial institution, for example.

And if you had something like that, then instead of creating a new regulatory structure, the, you know, big firms of the world who do a pretty good job of leasing themselves, would all of a sudden feel less sense of ownership over it as opposed to the firms that blow up and reconstitute themselves and all sorts of stuff like that. So I think having big institutions with some skin, again, makes sense. It could be FHA, it could be some -- but someone in the chain should be there.

MR. SEIB: Let me turn, if I could, to the fed policy, the question you addressed in the paper. And I wonder if you could talk about it on two levels; one is -- policy, how much did the fed policy decisions contribute to the credit bubble we're talking about here; and secondly, how much -- or was there any kind of a fed failure to use its power more aggressively and not curtailing abusive lending earlier, is that something that should have happened, could it have happened?

SPEAKER: Well, I will answer that. Could I just spend a couple of minutes, I want to -- one other point on the Fannie/Freddie issue. I think it's important -- I agree with the points that have been made.

But I think if one says now that we should use Fannie and Freddie, I think we need to have a conviction that we can accomplish something using them, that we cannot accomplish using the FHA, given the long standing concerns about the underlying regulation of Fannie and Freddie. And I'm not persuaded that there is such a thing. We talked about the -- about Fannie and Freddie, maybe securitizing some of what are now subprime mortgages, redefining them to be conforming mortgages. We have to ask, what happens to the risk of those mortgages if we charge that to the individuals. That seems to me very comparable to having the FHA help to ensure a mortgage, but charging the premium to the household.

If we instead expect that Fannie and Freddie will just sort of bear that risk somehow, then we actually are potentially increasing the systemic risk to those organizations, or we're just saying that, well, there's some other subsidy that will make them -- redirect some to this purpose.

Maybe that's right, maybe there is a way to force them to redirect some of this underlying stuff -- that purpose. But we could to the FHA just explicitly subsidize the insurance premium in a way that I discussed earlier.

So I think we've -- in deciding what to do, we need to see a real advantage to using Fannie and Freddie. If somebody said to me that my objection to using Fannie and Freddie helped its greatest liquidity crisis in the housing market -- standing on a -- putting out a fire, and somebody hands you a bucket of water, and you say, well, gee, I don't really like that bucket, but you have a better one, when you ought to just be throwing the darn water on the fire. But I think the problem here is, there actually is another bucket next to the Fannie and Freddie bucket labeled FHA that I think can accomplish many of the same goals with lower costs.

SPEAKER: Just to the minimum on that, there's presumably -- I think that argument has considerable force in the subprime area. Presumably, there's a fair amount of lost demand in the economy associated with -- that could potentially be addressed because the spread between the jumbo mortgages and the conforming mortgages has soared. And there isn't a natural FHA tool for addressing that problem.

So I think your argument, which I think has considerable force, applies only to one of a possible use of the GSE's.

SPEAKER: That's right; I think mounting a vigorous defense of the $417,000 threshold is difficult. I would -- it still worries me because of the underlying problems, but I -- my argument -- on that.

Now, your issues about the fed, what I've written in this paper is, I think looking back at monetary policy over the past half of a year, the Federal Reserve has done a very good job, and that the criticism that has interest rates too long for too long is basically misguided.

It's certainly true that those low interest rates help to fuel the run up in housing construction and house prices. But the feds job is to focus on the -- economy. And in judging their policy, you need to judge what happens to the overall economy and not what happens to the particular sectors. If the Fed had run a significant tighter monetary policy in 2002, 2003, 2004, a significantly tighter policy, that would, in fact, have restrained in the excess in the housing market. But it was done so at the cost of significantly higher unemployment during that period -- already, quite high. And the game might be a reduction in unemployment over the coming year.

But, in fact, the consensus forecast is the unemployment rate will stay out of a low five percent through next year given the Federal Reserve action already and any subsequent action that the Fed might take.

The idea that we should have traded off much higher unemployment then --we already had significant resources, significant pain of high unemployment in order to keep the unemployment rate possibly below five percent through next year -- stand up.

And on the regulatory fund, I think it's much less clear. My sense is that a regulation was not sufficiently proactive on the part of the Federal Reserve or the other regulatory agencies.

As Larry said, the expansion of the subprime market has done a lot of very good things. And Larry -- decide and find a way to decide how much lending to risky borrowers do we want, I think it's a very good one. But I think there is a pretty strong case that we have allowed too much of that in the past several years. There's a set of evidence of households in general don't understand the intricacies of all the financial -- There's a natural information asymmetry between what the lenders understand about the mortgage product and what the borrowers understand about the mortgage product.

And there's evidence in particular that households that don't understand the extent to which their mortgage payments might rise over time, exactly the reset problem that we think we -- through all these foreclosures. And that that lack of understanding is particularly acute among low income and less educated borrowers.

There's a general I think supposition here, not that the regulators are smarter in a general sense than the private market, but that particular issue of complicated financial transaction for the average person does not understand all the details of that, and that thus, the government should have a role going forward, and -- starting several years ago to, in my view, restrict some of the mortgage products that can be offered, as well as continuing to work the increased financial literacy and so on.

MR. SEIB: Roger, I'm curious to your thoughts on the regulatory question, but also a related one which is one of the issues that arises here, is whether there should be more regulation of non-bank financial institutions than there is now, and I wondered if you could address that and to the overall regulatory climate that everybody is thinking about as a result of the problem we're discussing?

MR. ALTMAN: Jerry, I really don't know the answer to that question. And I attended the Federal Reserve Symposium recently in -- there was a lot of discussion at that point, there was not much agreement on it, and I, for one, would have to know more than I now know to answer that.

I know that there is some greater cooperation going on now between the fed and state regulators as it relates to the mortgage finance system. And there is, of course, the slight digression, but there is, of course, the, I guess it's called a Homeowners Equity Protection Act, which allows the fed to regulate rather widely and might be used more forcefully than it's been used in the past. I'm not an expert on that statute, but I think there's an argument for using it more forcefully.
But on your question, I would just have to know more. I don't have an answer to that, maybe other people here do. Larry, go ahead.

MR. SUMMERS: Do you want to talk about HOPA?

SPEAKER: No, I think HOPA and TELA are things that the fed has said they're doing work on, and the Chairman of the Federal Reserve said he would be reporting back on the work they're doing on HOPA and TELA, and we should see what they say, that would be my instinct.

SPEAKER: Look -- couple briefings; first, I think the fed over the last 20 years has had something that's much closer to a golden glove fielding average than it has to a batting average in terms of getting its decisions right.

Having said that, I think when the Fed encouraged the choice of subprime mortgages rather than fixed rate mortgages, it will, excuse me, when it encouraged adjustable rate mortgages rather than fixed rate mortgages, it will not be remembered as its finest hour and sort of placed it on the wrong side of history with respect to the developments of this problem.

Second, I can't help but, if I listen to this, feel they are referred to Noah's Law, you're rewarded for arcs, not predicting rain, there's a kind of intermediate which is forming a committee to think about arcs. In 2002, we tend to be rewarded for that and there sometimes can be a tendency to confuse that with the building of arcs.

I am also not certain what the right regulatory structure is in addition to all the complexities in different kinds of institutions and so forth. It seems to me there's a deeper reason to find this a difficult issue. Here's a one paragraph summary of the history of American economic regulation in a whole variety of spheres, I think principally in transportation. There's an industry, it's not -- it's unregulated, some stuff happens that's bad for consumers. Congress decides it wants to regulate it so it would be better. The industry is outraged, fights the regulation tooth and nail. Twenty years later, the only people who are paying close attention are the industry and the regulators, and the regulators come increasingly to adopt the posture of the industry.

The industry comes to see more government sanction because the regulators are involved with it. The progressive side of the argument shifts from being for regulation to being for deregulation so it won't have the captive regulator.

That, I would suggest, is roughly speaking, the history of the CAD and airline regulation. That is the history of pipeline regulation, the Federal Power Commission, that's the history of the Interstate Commerce Commission, and in some ways, the history of variety of kinds of regulation and federal involvement and medical care through various aspects of medical care.

And without knowing what we should do, I make the prediction that if we have substantially increased financial regulation, many of the people who are most vigorously protesting that regulation 35 years from now will be most concerned to preserve it because of the barrier to entry that it will represent. And so I think it's quite complicated to know what it is that should be done. And you have to listen to people with a very clear sense of their self-interest.

MR. SEIB: So, Larry, how does CAFE standards, Corporate Average Fuel Efficiency standards, fit into that little regulatory world view?

MR. SUMMERS: We're not there -- we haven't had it -- we haven't had it long enough. Well, there is a certain amount of activity within CAFE that is directed, getting competitive advantage from my company and so forth. Unfortunately, they haven't been very good yet at figuring out a way to use CAFE to stand against Japanese cars.

But if you imagine that we were making smaller cars and they were making the bigger cars, then you know where CAFE would go. So you're right that it takes time and it won't --

MR. SEIB: And arguably, CAFE doesn't fit into your view?

MR. SUMMERS: CAFE has not yet fit into my view.

MR. SEIB: Because CAFE --

MR. SUMMERS: Absolutely; I would not want --

MR. SEIB: Has served to undermine the industry?

MR. SUMMERS: CAFE has probably to date not contributed to the -- has probably reduced the profitability of the industry, I suspect that that's right, yes, I think that's fair.

MR. SEIB: In other words, another version of your theory is, all of your precedent points, then the industry ultimately captures the regulator and they both go down beneath the waves?

MR. SUMMERS: That's another possibility, absolutely. But we -- let me pose one last question, I'll pose it to Eric and others can jump in before we turn to the audience to take questions. Maybe the most forward looking question, the one we were discussing in the hallway outside earlier I think, which is, how likely do you think it is that we've already seen the bulk of the market reaction to the problems we're discussing here, or how likely, by contrast, is it that we've only started to see the reaction a good bit more?

MR. MINDICH: If you get the history questions, I get -- questions -- probability and so it's hard to kind of couch it in those terms. What I would say is, I think that what we've seen is the -- in all likelihood, I think we've seen the financial market leading the economy reaction, meaning, you know, the crisis, you know, whatever seems to have passed.

I think that today we're in a world where almost every financial institution has got less capital than they thought they were going to have, less economic, less regulatory capital, lesser -- than they thought they were going to have, more VAR, more balance sheet, and so they -- They all learned a lesson that you shouldn't do that into the panic, you should do it when the sun is shining and the sky is blue, that should take three, six, nine months, and everyone is waiting for that, and that's certainly what it would say, they'd say but all bets are off if there's a problem in the real economy.

And I think that, you know, you say what's the probability that we're going to have a problem in the real economy the next, you know, three to six months, which I would say I think is a pretty reasonable probability of that.

I would say the kind of economist in me says it's hard to see that being much more than, you know, 35 or 40 percent, but my traders field tells me it's probably closer to 60. And I think if you see that, then I think there's still a large wave of de-leveraging to come, because it really hasn't happened yet.

I mean prices have moved, but you know, the paper hasn't moved. And I think that -- I think if that happens, you will have the coincidence of the financial markets and the real economy happening at the same time, and that's probably --

SPEAKER: Roger, do you have a thought on that?

MR. ALTMAN: I agree with Eric's sense of the likely economic impact. And I think there's going to turn out to be a negative wealth effect, you know, where much of recent years consumers who are homeowners, and that's most of them, mentally marked up the value of their homes, or in many cases, actually extracted it in financing or refinancing, but felt more flush because of their knowledge of rising home values. Now that's working in reverse because we're entirely aware of declining home values, they all know that. And you're seeing right now, even the last couple of days, in the reports of some of the retailers, the major retailers, signals that -- signals of weakness, let alone the widespread marking down forecast of 2008 by all the leading forecasters.

And so we are going to have a weaker 2008. I agree with Eric, I think the -- maybe my odds would be a little different. I think the odds of an outright recession are fairly modest, but the likelihood of a meaningful slow down, which I would define as growth in the one to one and a half percent rate, something like that, are quite high.

And then in terms of how much of this have we seen in the credit markets, I think there's an argument that the low point in the credit market as a whole has been reached or passed. I'm not sure I'd bet a lot of money on that, but I think perhaps it's the case.

But the mortgage issues have just begun to play out. Most of the foreclosure notices that will be sent out to homeowners have not yet been sent. And, of course, most of the foreclosures then that will occur have not yet occurred. And I don't have these numbers quite right probably, but something like three times the number of homeowners who will get foreclosure notices between now and the end of '08 have not yet received them. So that whole process, the staging through of the subprime crisis, that's in its early stages. And I might have just digressed to say --

one thing we haven't talked about much this morning is, there is an opportunity to furnish money to community organizations.

I think, Bob, you mentioned America Works, but -- who are the only ones really in a position to offer counseling, on the one hand, and actually perhaps participate in restructuring mortgages.

I've seen estimates that about one-third of the homeowners who will receive foreclosure notices might be in a position with the right type of help and a little money to convert those -- convert adjustable rate mortgages into fixed rate mortgages which they could service.

And so -- but the only organizations in the country that are in a position to help those people, in my judgment, are community organizations, and they don't have the money. Now, there's a tremendous, obvious problem with trying to figure out which community organizations are qualified to help and which are unqualified, and we just deposed that against the usual process in Washington allocating according to every congressional district and so forth, and you can say to yourself, well, it's too much trouble. My own view is, there is a way, and there have been proposals made, of course, Senator Schumer's made some and others, for Congress to appropriate funds which would be provided to community organizations to help on counseling and actually help on restructuring the mortgages, where sometimes you'll have to put some money up front to reduce the lender to convert the mortgage and the restructuring. And I think that's something that Washington should be doing.

SPEAKER: I agree with the comment about the counselors, and Neighbor Works is really the largest, and we've had lots of meetings in Treasury bringing all of the counselors together, how fast can you scale, what money do you need to scale, what are best practices.

And, you know, counseling firms do lots of things, and they counsel on all parts of consumers debt structure. And we've been trying to suggest that today is the time to maybe focus your business model most on the mortgage issue, and so as to help the largest number of people that we can.

And it gets back to my opening comments about, it's really a free -- dance, where basically you have to identify early, which really the person that has that information is the servicer. Don't count on people in need to self-identify; they won't, for lots of reasons. So identifying as early as you can via the servicers, getting them in touch with the independent counselors, and then trying to organize the right product mix that puts the people who can stay in their home in a position to have the best success, and it's really that free part process. And several have suggested you can't solve all of this. There are going to be, you know, issues and people that are unsuccessful, and it has to be focused on single family homeowners, people in their homes, and not for someone that owns 11 condos in Florida on --

MR. SEIB: Larry.

MR. SUMMERS: I think there's -- I agree with what was said about the counseling. I think there's one aspect of all of this that we haven't focused on this morning, which is the global element.

Nobody knows for sure what's going to happen, but many imagine that in an environment in which the U.S. economy is weakening and possibly going into recession and in which U.S. financial institutions are in a more complex posture than there were before, that there will be some tendency for the flow of capital to the United States to dry up the past predigest rates that potentially puts pressure on the dollar, and we'll have a set of consequences.

One set of consequences will be that a variety of American industries may be more competitive, which will be a tendency to -- to demand. Another set of consequences may be to get even more nervous about countries whose asset values are falling. Almost certainly if the rest of the world were to do what the United States has been encouraging it to do, to not -- effect for the last 15 years, which is to put more emphasis on stimulating domestic demand and less emphasis on relying on U.S. demand as a vehicle for encouraging their exports, much more of that would almost certainly be available for everybody in the global economy.

And so I think it's very important in that respect and others that we don't have time to talk about not to lose sight as we think about this whole constellation of problems of how open the world is. And if you think about all the kinds of financial institutions who are -- who have turned out to hold some of this paper, one is very much reminded of the importance of the global -- good point.

MR. SEIB: Let me see if there are some questions. What I would prefer to do, though, I'll point out the three people, and I think there are microphones floating around. Why don't we do -- I'll do a series of three questions, I'll jot them down, and then in the interest of efficiency, I'll then pass them around to the panelist that seems appropriate. If you can identify yourself before you ask your question, that will be great. Why don't we start there, that's one, two, and --

SPEAKER: -- information. We have stock analysts in the tech bubble and now you have these ratings agencies. We understand the principal agent problem. We understand why these professions do this, because they're paid to do that, fine.

The surprise is that the money managers take the advice although they didn't pay for it and then turn out surprised when the advice wasn't that great. It's like Coca Cola hiring McKenzie to come and advice on the restructuring but Pepsi paid for McKenzie, and then Coca Cola is surprised that the advice wasn't all that great.

So, I mean you come from a business of part of the money management industry which is sort of premised on the idea that most of the traditional investment managers are doing this. That's why they're not that great. That's why you can do better.

Do you see over time -- and this gets to this core issue of how -- how much government needs to intervene to regulate, how much the market can fix itself. Do you see overtime the investment management business evolving to a point where rather like hedge funds it does more internal proprietary research and relies less on dubious and conflicted external advisors, who not surprisingly aren't that great?

MR. SEIB: Why don't you go ahead because it's pretty specific? Why don't you go to that one person and then we'll roll on from there.

SPEAKER: Thank you for that question. I -- I think it is a -- I think your observations are all right. I would say I think that the -- I'd distinguish between, you know, a few of the different, you know -- a few of the different parts that you say kind of for different reasons.

You know, the auditor has, you know, nonpublic information to access to management the ability to count widgets in the factory. You know, you just must rely on them. You know, you just can't -- it's not efficient for the -- we should be organized that way.

In the world of equity research, one of the big problems that we used to deal with was the fact that people didn't really value our research.

There are, you know -- I'm sorry, you know, kind of formerly in the investment banks, and so, partially because of the research center but partially because the world was going that way, the investment banks have changed their business model to be more value -- to be more value lead and they have.

At the same time, hedge funds and other folks have been doing more proprietary research and that is increasing part of what's happened, which is why commission rates continue to steadily go down because the cost of execution has gone down, the value of that research has gone down, so I think you'll see more of that and you already have.

I think the issue of ratings is a very, very tricky one because you know, there is -- there are whole classes of investors that, you know, essentially don't do their own work on it and certainly rely on the ratings and that's imbedded in whether it's the insurance system or any of those other types of things.

And so I think that that is a very -- it's a -- and I think because of that we really do need ratings agencies that are going to do that and we shouldn't necessarily rely on individuals to do that.

I would say that -- the last point I'd make is that the big -- one of the biggest, you know, un-talked about problems with the whole securitization market has been that -- is that investors have just outsourced their work to the rating agencies, you know, kind of lock, stock, and barrel. And you know, when you were dealing with single name stuff, you couldn't do the work on it.

You know, someone had a -- someone at Bank One had a credit file on some, you know, Midwest thing of someplace, and instead, most of those folks don't have those credit -- you know, don't have that information now.

If you want to go do the workout, you know, you got to go kind of figure out what it was because no one cared that much. And outsourcers don't care about those part of 100 name securitization and it was a correlation trade and all sorts of stuff like that and so you need to -- and so, when you ultimately have a problem, you know, just going back recreating that information, creating that history with the borrower and all sorts of stuff like that is going to be hard.

And my guess is that people are going to wind up having big rewards for doing that, and that's going to be the next distress cycle where people are going to do it but it's going to be name by name work in that. And there will be rewards for the folks that do that, but it's just going to be a small part of the market that's geared to be able to do that because it's hard and expensive to do.

MR. SEIB: Let's do that one and two and then we'll go from there.

SPEAKER: (Inaudible) from a D.C. based consulting firm. So, my question is for all of the speakers and especially Professor Summers.

You just mentioned the global impact of this prime market mass. Some economies still attribute at least part of the reasons of this situation, I mean, causing success in liquidity to the global (inaudible), rather than the money supply of central banks.

So, my question is how do you view this situation? Is this the prime market mass or financial disruption, a start of correction to the global imbalances or this very aggressive (inaudible) global imbalance, or all these factors have no -- have nothing to do with global imbalances? Thank you very much.

MR. SEIB: Why don't you go ahead?

MS. CHAY: Natasha Chay from Georgetown University. A question about hedge fund. So, theoretically speaking, the ability to move huge amount of capitals across sectors and across borders will increase the fluctuation of real investment and financial investment within a sector or a country.

So, do you think that the increasing activities of hedge funds and private equity funds will increase the risk of the financial system in terms of volatility?

And in the long run, what do you think -- in which way do you think hedge funds and private equity funds will alter the way the financial market functions? Thanks.

MR. SEIB: All right. Let's -- Larry, you want to talk first about global impact and if it is a start of a correction of global imbalances or something different?

MS. SUMMERS: Look, I think the global imbalance thing is rooted in desired savings and investment patterns in the United States and desired savings and investment patterns in the rest of the world.

I think the -- I think in terms of proximate causes, the way to -- the way to understand the crisis that we're in right now has more the character of what Roger and what Eric talked about.

You know, it's like talking about what started World War I. Was it an assassination in Sarajevo or was it a whole set of broad political dynamics that were going on?

And whether we did have global imbalances or whether we didn't have global imbalances, after a long period in which markets went only up, there was going to be leveraging and there was going to be some problem, and there was going to be a downturn.

So, I don't think it's right to blame the financial -- blame the global imbalances for the problem. And I think it's very important, just in terms of having some perspective here if you look back a little bit.

There has been no five years in all of human history when the world economy has grown faster than in the last five years. There has been no quarter century in the history of the United States and probably in the history of any other country when the volatility of GNP from year to year has been lower than in the last 25 years.

There have been very few, if any, protracted periods, even including the recent episode in volatility, even including what happened in 1998 when the volatility of the stock market or the volatility of the bond market in percentage terms ahs been as low as they have been.

So, I don't want to minimize the degree of dislocation now and I certainly don't want to minimize the fact that there are very important prospectively. But I think it's very important to understand that in terms of economic activity that affects real people or in terms of actual instability and lost wealth in the financial markets, we are living in a period of far less volatility than has been the historical norm in our country.

MR. SEIB: Global imbalances? I guess, Eric, I'd have to turn to you but maybe Larry too. Hedge fund? You live in a hedge fun world now, but you really live in a hedge fund world now.

I guess the question was use the ability --

SPEAKER: These are fun questions.

MR. SEIB: Volatility, ability to move capital across borders.

MR. MINDICH: Right, sure. Yeah. I would say that on balance hedge funds and private equity funds do an enormous amount to reduce the volatility, you know, of the end outcomes of these types of things.

You know, the ability to raise pools of capital to go into opportunistic places where there are shortages of capital is exactly what the industry, you know, is supposed to be doing, and they really are doing that.

There are examples just over the last month or two. You know, people sprout up new funds to buy the leverage -- you know, the LBO loans that haven't even sold and haven't even happened yet. There are, you know, lots of new funds being formed now to buy, you know, to buy distressed, you know, loans when there's no distress yet. But, they think there may be distress and that will be there to cushion that shock.

We and others are spending lots of time on the world of sub prime, you know, what kind of things can you buy to, you know, kind of profit from that wreckage. But that means that, you know, you have a, you know, a shorter, you know, type of, you know, a shorter and shallower type of thing.

So, I think on balance, that's the answer. That said -- and by the way, the whole -- that's tied up with all this whole securitization stuff, which basically means that large regulated financial institutions themselves, you know, are less likely to have, you know, are less likely to have those difficulties.

And, you know, but that doesn't mean that just because you have these organizations that you're not going to have periodic financial messes. And the likelihood is that hedge funds are going to be at that scene of that accident.

There are thousands of -- there are private equity funds, whatever, that folks are going to be involved in that. And so the proximate cause of the headline, you know, is going to be xyz hedge fund was involved in that accident, maybe even exacerbating that accident at that moment in time, probably will be.

But on balance, you know, the net effect of the industry is very large. And if it weren't that hedge fund having that problem, it might have been continental Illinois or Orange County or you know, some other thing that we've seen over the course of history that's kind of been there that essentially you've outsourced a lot of that to the hedge fund role.

So, I caution you when you read about those accidents in the future that you have that perspective in mind.

SPEAKER: Can I make --

MR. SEIB: Sure.

SPEAKER: -- make two provocations here. The first is just because Milton Friedman said something simplistically doesn't mean it was entirely wrong. And Milton Friedman said what I think is actually a first thing to say about this type of topic.

He basically said if you're a speculator, how do you turn out to be a profitable speculator. You turn out to be somebody who bought low and sold high.

If you want to stabilize something, how do you stabilize it? You buy low and you sell high. So, there is a presumption that speculative activity that is profitable and is continuingly profitable is probably operating in the direction of stabilizing things.

I would argue that one of the perverse consequences of various regulatory things we've done over the years is that in a variety of respects it's been made more difficult to sell something short; that is to say to promise to -- that is to invest so you profit if it goes down.

And one of the consequences of that has been that the bubbles have all been bigger, because people who wanted to express the view that they were bubbles couldn't sell in ways they would have liked to and that has increased instability.

Here's a second thing, and I think here I probably have a slightly different view than Bob does. If you look at the history of finance, 1930s in the United States, the SNL crisis in the United States, what happened in Japan in the

1980s, literally millions of people, probably tens of millions of people have lost their job because traditional financial institutions that didn't mark the market everyday, that didn't trade things rapidly, that kept all their loans all together without any trenching or any derivatives, screwed things up. And the economy went way down and millions of people lost their jobs.

And to this point in financial history, one really can't find almost any examples where large numbers of people have been unemployed or had their lives disrupted by anything to do with derivatives or hedge funds or mark to market or any kind of modernity.

And so, I think one has to be very careful about resisting the innovation. And I would make the further statement that if, as I don't expect but I do recognize the possibility, it turns out that what we're in the midst of is something that people will be writing about in economic history books 30 years from now as a real disaster -- that's not what I expect.

But, if it happens, the analysis of the disaster will basically be that the banking system shut down because the banks operating without these principle agent problems, without marking the market, made all these loan commitments for which they didn't charge themselves, for which they didn't mark the market on an instantaneous basis, they all flew back on the banks' balance sheets, and the banks' balance sheets were expanded and then, because they had all these loans that they weren't trying to make but got stuck having to make, they didn't have any money to make loans to drive the new businesses and to drive the new consumers and the like.

And the problem will have resulted from the slow motion, non-securitizing, non marking to market banks, rather than the fast -- rather than the faster actors. And I --

SPEAKER: You mean the mastodons of finance, like say Citigroup?

SPEAKER: Your term not mine.

So, I think -- so, I think we need to be very, very careful of taking the view that it's faster moving newer forms that are the sources of the instability, rather than issues that arise in more traditional institutions.

MR. SEIB: We probably have time for one last question, and it should be from Bob, I guess, but --

SPEAKER: It's not so much a question.

Leave aside the questions of banks for a moment, this is a subject Larry and I have discussed at least beginning in the last 1990s when we were both at the Treasury.

I think Larry makes a lot of -- makes some number of possibly reasonably good points that under some circumstances could be (inaudible), but -- no, I think he's actually reasonably thoughtful on this.

But, I do think there is a real question, as Larry and I have discussed this for a long time, exactly what effect all this derivatization and securitization is really going to have over time.

And Eric, I don't disagree with you in some sense about hedge funds, but I'd also make the case under some circumstances, when hedge funds start to get in trouble and they all run for the exit at the same time, then you can have an exacerbation of volatility.

And I think, Larry, the same thing applies in some respect with respect to derivatives, so that on the one hand, you could say that securitization, derivatives, and all the rest in many respects -- I agree with you, Larry -- do all the kinds of things you just said.

But I think you can also -- the sub prime situation probably would not have happened had there not been ability to finance through the CLOs -- well, CDOs, collaterized debt obligations.

Without getting into the technicalities of it, it's a whole structure, a whole structure of financial engineering that basically enabled all this to happen.

But I think it's a very complex question, and I think the points Larry made are very good points. This is a debate we really should have in a very serious way, in which people who actually understand, Bob, and you're capable of doing that through the President's working group so that we can try to -- I mean at least your people are -- so that we can --

SPEAKER: It's good training I had, Bob, that he just mentioned.

SPEAKER: -- so that we can try to better understand all this.

I personally think that there is at least a low probability -- I think it probably is low probability, low probably risk that at some point all of this securitization, derivatization, which should now become a vast multiple of the underlying cash markets in many respects could create exacerbation problems that are very serious.

I may be wrong. That may not be a correct concern, but I think it's the kind of thing that we really need to understand so that we don't wake up one day and all of a sudden find this all imploded on us and then we say to ourselves why haven't we paid more attention.

And I'm not saying that's right, that anything I've just said is right. I'm just saying I think it's very much worthy of consideration.

SPEAKER: I think -- I managed to make myself heard so -- I think Bob is absolutely right. You're dealing in a world of probabilities and it's a question of what the probabilities -- a question of what the probabilities are. I just think one needs to recognize the other side. If you'll look in total at homeowners, at the availability of credit, at the disruption to the economy, the current situation could get quite substantially worse without being as bad as the mess that the S&Ls and the regular banks with no derivatives or no anything made as recently as -- made as recently as 1950 -- excuse me, 1990.

And if you'll look at a graph of the volatility of housing starts, even with all this securitization and derivatives and all this stuff, you know, if you look at it as a graph, those electrocardiograms going like this. You know, for the last 15 years, it's kind of -- it is sort of wiggling.

Japan had a real committed, real serious set of policies through the eighties of stopping all this kind of stuff because it really could be terribly, terribly destabilizing and dangerous, and you know, the risks ended up not dispersed and you had collapses.

So, I think you're absolutely -- I think Bob is absolutely right that there are risks associated with this that we need to think very hard and try to anticipate them as best we can and minimize them, that there may be some particular aspects of this where the benefits are exceeded by the extra risks that are taken.

But I think we need to very much keep in mind that the mildest systems have a track record of many, many, many disasters. And in making a balance of that innovation, that leaves very much to be remembered.

SPEAKER: Jerry, can I make one comment? Out of very, very long experience, very long experience, that is Larry's way of saying Bob is actually wrong.

SPEAKER: I can't top that. Thank you. Listen, thanks to Bob and Jason, to the Hamilton Project. This is a great group and I do think an incredible discussion. And I suspect we can all come back and pick it up in six months right where we left it off.

So, thanks very much.

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