Reducing the Likelihood of Financial Crisis

Douglas W. Elmendorf
Senior Fellow, Brookings Institution

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Chairman Schumer, Ranking Member Saxton, and Members of the Committee, I appreciate the opportunity to appear before you today.

The current financial crisis in the United States poses two separate challenges for economic policy: one, to resolve the immediate problems; the other, to reduce the likelihood that these problems recur. My testimony will focus on the second of these challenges. The diagnosis and prescriptions I will offer are based on a report I am writing with my Brookings Institution colleagues Martin Baily and Bob Litan, of which a preliminary draft will be released this Friday. However, I alone am responsible for any errors or inadequacies in my comments.

The U.S. financial system remains in a perilous state. I share the view of some other observers that the worst of the credit crisis is probably behind us. But that is by no means certain, and, even if it turns out to be right, the return to normal financial conditions will be a slow and uneven process.

Indeed, we have already seen two false dawns during this crisis. Last October and again this January, financial conditions appeared to be stabilizing—only to be followed by renewed widening of risk spreads, further declines in asset values, and struggles for survival by some financial intermediaries. The Federal Reserve has responded to this turmoil vigorously and, in my view, appropriately by reducing the federal funds rate 3¼ percentage points and by providing significant liquidity as the so-called "lender of last resort." Through these actions, the Fed has so far prevented what might have been a cascade of defaults and institutional failures. Hopefully, the relative calm since the sale of Bear Stearns in March is a precursor of further stabilization.

Still, estimates suggest that billions of dollars of mortgage-related losses have yet to be declared by U.S. financial institutions. Interbank loan rates remain elevated as banks hoard liquidity and continue to be concerned about the creditworthiness of other institutions. The slowing of the economy is depressing loan repayment rates. Thus, the risk of a large institutional collapse has been reduced but not eliminated. More important, an absence of dramatic events going forward will not imply that financial intermediation is back to normal. The weakened state of banks' balance sheets will make them less willing to lend to households and businesses for some time to come. For example, the Fed reported recently that a large fraction of banks tightened lending standards and terms across a broad range of loan categories in the first quarter of the year. Many banks have raised additional capital to bolster their balance sheets, but much more needs to be raised. If that does not occur in a timely way, we could face a constriction of lending to households and businesses analogous to the Japanese experience in the 1990s.

The turmoil in the financial system is important primarily because of its impact on the overall economy. The latest data on spending, employment, and production suggest that the economy is very likely in recession, and several forces are exerting further downward pressure on economic activity:

- Housing construction continues to fall sharply, and the large supply of unoccupied homes offers no comfort that construction will recover soon.
- House-price futures and analysts' estimates of sustainable house prices point to further declines, and the resulting loss in household wealth will depress consumption to a growing extent over the next year.
- The tightening in lending that I just mentioned will further restrain spending, as will the weak level of consumer confidence and the rising trend of home foreclosures.
- And this year's further rise in oil prices amounts to a tax on households whose full effect on spending has probably not been apparent yet.

I do not mean to suggest that all of the economic news is bad. Data for the first quarter of the year were more favorable than many had feared, and the decline in the value of the dollar is buoying net exports. Moreover, powerful economic stimulus has been set in motion through the actions of the Federal Reserve and the tax-cut legislation passed by Congress in February. Therefore, I share the consensus view among forecasters that a mild recession is the most likely outcome. But I would caution that a more serious economic downturn is entirely possible.

The experience of the U.S. financial system and economy during the past year vividly demonstrate the need for reform of our financial regulation and supervision. Let me offer four principles to guide reform and the specific recommendations that follow from them:

Principle #1: Financial Regulation Should Try to Keep Pace with Financial Innovation

This principle may seem self-evident, but it is worth stating explicitly because it is so important. Financial innovation has been a very positive force in our economy, but it also creates problems. New products, new markets, and new institutions are usually more complex and less transparent than their predecessors; they tend to boost leverage and risk-taking; and they tend to skirt existing regulations and supervisory attention. In recent years, regulation and supervision of financial institutions did not fully recognize the problems that were building and did not adapt enough to put effective limits on these problems. Going forward, we need to be sure that regulation evolves along with the financial system so that we can reap the greatest benefits of innovation.

Financial innovation has benefited our economy in at least three important ways:

- Innovation in recent decades has extended good opportunities for borrowing and saving to people further down the income scale. The late Ned Gramlich, a former governor of the Federal Reserve, emphasized last year that the needed reforms of subprime mortgage lending should preserve the good aspects of such lending. He explained that the subprime expansion had enabled many households with low income and poor credit histories to move out of undesirable rental housing, so that even with the current problems, many households will have benefited from this home-owning opportunity. On balance, the democratization of our financial system has been a good thing.

- Innovation has improved the allocation of capital and the distribution of risk in our economy, thereby spurring long-term growth and raising people's well-being. Economists who have systematically compared the experiences of different countries have found that financial development has a significant positive effect on growth rates.[1] In our country, we know that improved access to credit for smaller and riskier businesses—for example, through the expansion of venture capital and the so-called "junk bond" market—has provided critical funds for new industries.

- Innovation has probably helped to stabilize the economy. This statement may be surprising as we stand on the brink of a recession that was caused, at least in part, by innovation run amok. However, I wrote a paper several years ago with Karen Dynan and Dan Sichel in which we tried to catalog the channels through which financial innovation affects economic volatility. We identified myriad channels, with different aspects of innovation pushing volatility in different directions. On balance, we concluded that innovation likely contributed to the mid-1980s stabilization of the U.S. economy known as the "Great Moderation."[2]

Along with these benefits, however, financial innovation also creates problems:

- One key problem with innovation in recent years is the high degree of complexity and low degree of transparency. Nontraditional mortgages—including interest-only mortgages, negative amortization mortgages, and mortgages with teaser rates—were apparently not well understood by many who borrowed this way or lent this way. Unconventional credit-market instruments—such as derivatives on asset-backed securities—were intrinsically complicated and unfamiliar even to sophisticated investors, and they had a very short track record that was exclusively from a period of rapidly rising house prices. Transparency was further reduced by arrangements that purported to insulate investors from risk, such as credit default swaps, bond insurance, and shifting liabilities off balance sheets.

- Another key problem is the increasing divergence of incentives between the ultimate investors and the people guiding financial decisions. These "principal-agent problems," as economists call them, are endemic in financial markets, but recent innovation has exacerbated them. One example is mortgage brokers who were compensated for the volume of transactions they initiated and had little incentive to monitor the quality of loans they made. Another example is credit ratings agencies that are paid by the sellers of securities rather than the buyers; as securities became more complicated, investors' reliance on the agencies' judgment increased.

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[1] For example, see Aubhik Khan, "The Finance and Growth Nexus," *Federal Reserve Bank of Philadelphia Business Review*, January/February 2000, and Ross Levine, "More on Finance and Growth: More Finance, More Growth?," *Federal Reserve Bank of St. Louis Review*, July/August 2003.

[2] See Karen E. Dynan, Douglas W. Elmendorf, and Daniel E. Sichel, "Can Financial Innovation Help to Explain the Reduced Volatility of Economic Activity?," *Journal of Monetary Economics*, January 2006, and Federal Reserve Board Working Paper, November 2005, http://www.federalreserve.gov/pubs/feds/2005/200554/200554abs.html.

These problems diluted the potential benefits of the innovation. Democratization of credit is counterproductive if many people end up with loans that are inappropriate for them. Capital is not allocated to its highest-value uses if everyone thinks that the risks of investment are borne by someone else. Lack of transparency and divergent incentives caused a run-up in financial risk-taking, both in the assets purchased and the degree of leverage used to finance those assets. These forces helped to fuel the housing bubble, and they greatly worsened the consequences when the bubble deflated.

In sum, financial innovators and regulators are in a race, and the regulators will always lose that race. But it matters how much they lose by. If regulators do not try to keep up, or are completely outclassed in the race, then much of the benefit of financial innovation will be offset by the cost.

Principle #2: Mortgage Origination Should Have Simpler Disclosures for Everyone and Limits on Offerings to Subprime Borrowers

Economists and others sometimes assume that having more choices improves people's well-being. Clearly, that is true in many cases. However, it is not necessarily true if people are choosing among complicated products without sufficient information or understanding.

A growing body of evidence demonstrates that people do not fully understand their financial arrangements. For example, researchers have found that younger adults and older adults tend to pay significantly higher interest rates than middle-aged adults, even after controlling for various personal characteristics.[3] This finding suggests different degrees of sophistication across households of different ages. Researchers have also found that households with low income and little education are less likely than other households to know their mortgage terms—for example, the extent to which their interest rates can change.[4]

Financial innovation that gives people more choices can make these problems worse. Newly designed mortgages are generally more complicated than older ones, and people have little experience with new mortgages—in their own lives or the lives of their friends and family members—to use in making decisions. More generally, the ability to borrow more is also the ability to borrow too much. Even in 2004, prior to the worst of the deterioration in lending standards, households with the highest ratios of debt to assets were more likely to be insolvent than in previous decades and more likely to face financial strain.[5]

Of course, protecting people from unwise choices is easier said than done. Financial arrangements that are unwise for some people in some circumstances are quite sensible for other people in different circumstances. Thus, public policy should improve financial literacy and

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[3] See Sumit Agarwal, John C. Driscoll, Xavier Gabaix, and David Laibson, "The Age of Reason: Financial Decisions Over the Lifecycle," Harvard University, March 2007.
[4] See Brian Bucks and Karen Pence, "Do Homeowners Know Their House Values and Mortgage Terms?," Federal Reserve Board Working Paper, January 2006, http://www.federalreserve.gov/PUBS/FEDS/2006/200603/index.html.
[5] See Karen E. Dynan and Donald L. Kohn, "The Rise in U.S. Household Indebtedness: Causes and Consequences" in *The Structure and Resilience of the Financial System*, Reserve Bank of Australia, 2007, and Federal Reserve Board Working Paper, August 2007, http://www.federalreserve.gov/pubs/feds/2007/200737/200737abs.html.

provide information needed for making informed financial choices. However, these steps are not enough in my view, and some limitations on mortgage offerings are also appropriate. Moreover, protecting people also reduces risks for the financial system as a whole, because people who understand their mortgages are more likely to be able to repay them.

Specifically, Martin Baily and Bob Litan and I recommend:

- Simpler mortgage disclosures, pre-mortgage counseling for subprime borrowers, and perhaps a default mortgage contract from which people could opt out.

- Further restrictions on the design of mortgage contracts under the HOEPA rules and a broadening of HOEPA coverage, both along the lines proposed by the Federal Reserve.

- Federal oversight of state regulation for all mortgage originators.

Principle #3: Financial Instruments and Institutions Should Be More Transparent

As we know from many examples, self-interest is a powerful economic force. Good regulation harnesses that force. I have already explained that one important problem with the new financial products and markets of recent years is their very low degree of transparency. By increasing transparency, we can give investors better tools to monitor financial risk-taking themselves.

The private sector is already moving in this direction. Many financial intermediaries recognize that they need to be more diligent in learning about assets before buying them instead of placing blind confidence in other people's evaluations. Going forward, investors will put less weight on the judgment of the credit ratings agencies. They will be more skeptical of assertions that certain complicated financial strategies have no risk. They will be more concerned about the underwriting standards that had been applied to loans underlying asset-backed securities. And they will be less likely to buy derivatives whose payoff structure they do not fully grasp. Warren Buffett has been quoted as saying that he only buys things he understands, and more investors will adopt that mantra.

Appropriate changes in regulation can aid investors in this process. Specifically, Martin Baily and Bob Litan and I recommend:

- Increased transparency in the mortgage origination process, as I have already described.

- For asset-backed securities, public reporting on characteristics of the underlying assets.

- For credit ratings agencies, greater clarity in presenting ratings across asset classes, reporting of the ratings agencies' track records, and disclosure of the limitations of ratings for newer instruments.

- For commercial banks, clearer accounting of off-balance-sheet activities.

- For derivatives, a shift toward trading on exchanges, which will encourage standardization of instruments.

Principle #4: Key Financial Institutions Should Be Less Leveraged and More Liquid

Even if private investors had perfect information, they would tend to take greater financial risks than are optimal from society's perspective. The reason is that taking risks in a financial transaction can have negative consequences for people not directly involved in that transaction. These spillover effects arise in part because of the risk of contagion in the financial system, and they arise in part because of the government safety net including bank deposit insurance and the role of the Federal Reserve as lender of last resort. The parties to a transaction have no reason to take account of these externalities, as economists label them, and this provides the traditional rationale for government financial regulation and supervision.

To be sure, the financial system is already moving to reduce leverage and increase liquidity. Those institutions with larger capital cushions are weathering this crisis far better than their less-conservative competitors, and they now find themselves in a position to purchase assets at favorable prices. Those institutions with greater amounts of liquid assets have been less subject to "runs" in which their investors scramble to get their money out first. These examples provide strong lessons for future institutional strategies. To highlight one example, the future will see less borrowing on a short-term basis to finance long-term commitments. That approach ended up hurting families who could not afford their adjustable-rate mortgage payments after the rates reset; it hurt so-called "structured investment vehicles" (SIVs) that were not viable when short-term funding costs increased; it hurt municipalities that borrowed in the auction-rate market and were suddenly unable to roll over their debts at previous rates; and it hurt investment banks that financed themselves heavily through overnight repurchase agreements. In the future, more borrowers will pay higher rates to lock in longer-term financing.

Still, these private responses should be accompanied by changes in regulation and supervision.[6] Specifically, Martin Baily and Bob Litan and I recommend:

- For commercial banks, capital requirements for off-balance-sheet liabilities, required issuance of uninsured subordinated debt, and closer public supervision of risk-management practices.

- For investment banks, regulation and supervision of capital, liquidity, and risk management.

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[6] Some analysts have argued that excessive leverage should also be thwarted by restrictive monetary policy. In the words of the IMF's recent *World Economic Outlook*, there may be "benefits to be derived from 'leaning against the wind,' that is increasing interest rates to stem the growth of house price bubbles and help restrain the buildup of financial imbalances." I disagree with this view, principally because monetary policy is a very blunt tool for preventing increases in leverage. More restrictive policy earlier this decade might have diminished the housing and financial bubbles, but only at the cost of significantly higher unemployment and lower inflation at a time when resource utilization was already depressed and inflation was falling toward the bottom of the Federal Reserve's comfort zone. See Douglas W. Elmendorf, "Financial Innovation and Housing: Implications for Monetary Policy," Brookings Institution, April 2008, http://www.brookings.edu/papers/2008/0421_monetary_policy_elmendorf.aspx.

- For bond insurers, higher capital requirements and closer supervision of underwriting standards for new products.

Conclusion

Let me conclude with three final observations.

First, my comments have focused on *what* should be regulated rather than *who* should do the regulating. That is not because I am enthusiastic about the existing hodgepodge of regulation. Rather, I think that regulatory reform needs to set priorities, and the highest priority in my view is not to change boxes on the organization chart but to change what happens inside each box. Insisting on a grand redesign of financial regulation may simply bog down the legislative process and ultimately accomplish very little. To be sure, the seriousness of the current situation and the impact on the housing and mortgage markets that directly affect so many people should provide political support for change. However, regulation of the financial system is substantively complex and will still feel remote to many citizens, and I expect that reform will be difficult to achieve.[7]

Second, the private and regulatory changes that I have discussed will raise the price of risk and therefore the cost of borrowing by risky borrowers. They will also reduce the demand for complex financial transactions, which in turn will diminish the rewards for undertaking this sort of financial engineering. These outcomes are appropriate in my view. During the past fifty years, the value added by the finance and insurance industry has surged from about 3 percent of GDP to about 8 percent. Much of that increase, and the financial innovation it reflects, were beneficial for the reasons I described earlier. But the events of the past year have shown that the latest steps in financial complexity and risk-taking, without appropriate advances in regulation, had smaller benefits and larger costs than many people initially understood. Some step-back in the upward trend of financial engineering should be sought and not feared.

Lastly, financial markets will always experience swings between confidence and fear, and between optimism and pessimism. However, effective regulation and supervision can reduce the frequency, the magnitude, and the broader consequences of these swings.

Thank you very much.

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[7] On a related note, I think that regulatory reform should focus on key financial institutions. Economists generally advocate a "level playing field" in which government rules are neutral across economically identical activities and thus do not distort private behavior. Yet, creating a completely level field for risk-taking and leverage is both impractical and unnecessary. It is impractical because individuals will always find ways to make risky investments and some will undoubtedly lose their wealth doing so. It is unnecessary because these phenomena create larger problems in some circumstances than others. Although mortgage-backed securities and their derivatives spread risks around the global financial system to some extent, significant exposures remained on the balance sheets of key U.S. institutions. It is their losses that have done the most damage to the functioning of the system and created the greatest concerns about future credit supply. Moreover, the Federal Reserve's recent actions show a clear benefit of doing business with key institutions. Tighter regulation can balance the effect of providing that safety net.