Initiative on
Business and Public Policy
at BROOKINGS

FIXING FINANCE SERIES – PAPER 1 | SEPTEMBER 2008

A Brief Guide To Fixing Finance

Martin Neil Baily and Robert E. Litan

The Initiative on Business and Public Policy provides analytical research and constructive recommendations on public policy issues affecting the business sector in the United States and around the world.

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SUMMARY

Whatever steps are taken in the short run to address the current financial crisis, there is at least broad consensus that financial regulatory and supervisory reform is needed to dramatically reduce the likelihood that something like the recent set of events never recurs. This piece is a brief guide to interested readers of principles for reform that we believe should guide policy makers to address financial issues, both in the immediate term and over the longer run.

In the immediate term, policymakers must set priorities. They include:

1. Setting up the new asset disposal agency, staffing it, and establishing a plan and timetable for selling the assets the federal government acquires through this process
2. Determining whether and how to shore up residential real estate markets by stemming the tide of future foreclosures
3. Providing more resources for the FDIC
4. Figuring out what to do with the two large housing GSEs, Fannie Mae and Freddie Mac, that are in "conservatorship." Options include
    - i. Returning them to the private sector, but much better regulated
    - ii. Privatizing them in some fashion
    - iii. Nationalizing them and having them become arms of a federal agency
    - iv. Gradually liquidating their portfolios

Then, we believe policymakers should explore what exactly went wrong before they attempt any longer term fixes. In short, our analysis suggests that the financial crisis had its origins in an asset price bubble that interacted with new kinds of financial innovations that masked risk; with companies that failed to follow their own risk management procedures; and with regulators and supervisors that failed to restrain excessive taking. Thoroughly understanding the origins of this crisis is a crucial step.

Over the longer run, the array of things that require fixing can seem so daunting and unique that it can be paralyzing without having a sensible framework to guide the effort. There are two ways to bring structure to this process.

One way is to think of the time-line of events that led to the crisis and address reforms at each stage. This could mean new rules for: mortgage origination; mortgage (and perhaps other asset) securitization; better oversight of and/or disclosure by credit ratings agencies; improved oversight of currently regulated financial institutions and possibly new federal safety and soundness and disclosure rules for other financial institutions that engaged in securitization and that ended up with the complex securities on their balance sheets.

A second way to structure and think about reform proposals is to ensure that they abide by certain fundamental principles. We suggest three:

1. Financial instruments and institutions should be more transparent
2. Financial institutions should be less leveraged and more liquid
3. Financial institutions should be supervised more effectively, with greater regard for systemic risks

Finally, we would counsel policy makers here to proceed expeditiously, but deliberately, to fix the problems with our financial system that are very much home-made. We should continue to take part in the discussions of these issues in the appropriate international forums, but we should not wait for international consensus to develop before we act.

INTRODUCTION

Americans reading the newspapers or watching the television coverage of the tumult in our stock markets and financial institutions over the past few weeks rightly wonder: what is going on? How can seemingly once solid rocks of American finance – indeed American capitalism – like Fannie Mae and Freddie Mac (the twin engines of mortgage finance), Merrill Lynch (the original stock market "bull"), and AIG (the nation's largest insurer) – either be forced to merge with other institutions or be forced into government hands—at least temporarily?

Even more shocking, how could the nation be on the verge of enacting the largest federal bailout in history on such a short time schedule? As we write this, Congress is considering an unprecedented proposal from the Administration to give authority to the Treasury Department, modeled on the Resolution Trust Corporation that disposed of real estate and other assets in the 1990s that the government inherited from failed savings and loans, to remove illiquid mortgage assets that are currently weighing down financial institutions and threatening the economy. The Treasury Department has asked for up to $700 billion to carry out this job, although the ultimate cost to the government will depend on the proceeds from the sale of the securities.

Less noticed, but also dramatic, was the Treasury's announcement that federal guarantees will be extended for a year to previously uninsured money market funds. This step was designed to prevent a run on the funds after one of the largest such funds "broke the buck" last week because of losses on Lehman Brothers' securities suffered by the bankruptcy of Lehman earlier last week. And, as if these efforts were not enough, the Treasury announced it was going to expand its program announced earlier this month of purchasing mortgage-backed securities to enable Fannie Mae and Freddie Mac to increase their purchases of these instruments to support the housing market.[1]

As a number of financial experts, including our Brookings colleague Douglas Elmendorf, have noted,[2] the Administration had another alternative way of addressing the financial crisis, which it rejected (though we cannot know how actively it was considered): It could have followed the model of the Reconstruction Finance Corporation established during the Depression (and, more recently, of the Fed's rescue of AIG) and selectively purchased preferred stock in failing financial institutions, while imposing the kinds of stiff conditions as the Fed imposed on Bear Stearns and AIG (severely haircutting shareholders and firing top managers). This option would have left troubled assets in the private sector, which should be better equipped to deal with them than the government, and probably would have done a better job minimizing moral hazard. The RFC model probably would not be as effective in liquefying the frozen mortgage securities market, however, and it could tempt the government to pour even more money down the road into some losing companies. In addition, the government would be left under the RFC approach with disposing of the assisted firms, or their assets, if they fail.

While we thus generally support the efforts of policymakers to avoid further chaos in U.S. and global financial markets through some means, it cannot be disputed that all of this financial firefighting may create serious long term problems. When government funds on a large scale are used to support private sector companies, without a clear quid pro quo or price to be paid for that support, there is

1. Henriques , Diana B. "Treasury to Guarantee Money Market Funds," The New York Times, September 20, 2008.
2. http://www.brookings.edu/opinions/2008/0919_treasury_plan_elmendorf.aspx

inevitably the problem of moral hazard and the encouragement of excessive risk taking in the future. Furthermore, the sweeping nature of the proposed rescue – benefiting a broad range of financial institutions holding troubled mortgage securities – will make it difficult for policymakers in the future to resist requests by other types of firms in other industries for similar treatment, and more broadly, may undermine for a lengthy period the public's faith in markets in a wide range of contexts.

Whatever steps are taken in the short run to address the current financial crisis, there is at least broad consensus that financial regulatory and supervisory reform is needed to dramatically reduce the likelihood that something like the recent set of events never recurs. In May, we joined with Douglas Elmendorf to produce some initial thoughts on this subject, in a document available elsewhere on this website, *The Great Credit Squeeze*[3]. The financial crisis since then has deepened, and new information continues to come to light. Like many others who are following these unprecedented events, we are being forced to rethink not only what we wrote only a few months ago, but to address a growing list of topics that the unfolding events are bringing to the fore. In the coming weeks and months, therefore, we intend to issue short briefings on selected financial reform topics, as part of a broader *Fixing Finance* project. We also plan a series of meetings with financial experts to discuss these issues. Ultimately, we will present our collected views either in a revised version of *The Great Credit Squeeze* or in a separate manuscript.

In the meantime, what follows is our brief guide to interested readers of principles for reform that we believe should guide policy makers to address financial issues, both in the immediate term and over the longer run.

3. www.brookings.edu/papers/2008/0516_credit_squeeze.aspx

Prioritize

Whatever one may believe about the specific recommendations in the Treasury Department's *Blueprint for a Modernized Financial Regulatory Structure*[4] issued in March 2008, the Department was right to suggest that policy makers must set priorities. The next Administration and Congress, in particular, should address first those problems that are most pressing, and then tackle those that are less time-sensitive.

Clearly, if Congress enacts the Administration's massive bailout proposal, the first priority will be setting up the new asset disposal agency, staffing it, and establishing a plan and timetable for selling the assets it acquires. We anticipate that if the proposal is enacted, Treasury will rely heavily on private sector financial advisors to assist with the purchase and sale of the securities, as well as management of the whole portfolio of assets before sale (although the pool of such advisers may be limited, since no adviser should come from an institution that sells its securities to the new agency).

A related priority item, if it is not addressed in a forthcoming mortgage securities bailout bill, is whether and how to shore up residential real estate markets by stemming the tide of future foreclosures. As it is now, analysts generally expect 2 million more homes to enter foreclosure in 2009, which should dampen, if not depress, home prices in many parts of the country. During the summer of 2008, the Administration and Congress enacted legislation to guarantee an estimated 500,000 residential mortgages, if the lenders and borrowers agreed to a write-down of approximately 15 percent below current appraised value. If the economy continues to weaken and housing prices continue to fall, there will be political pressure for another home mortgage relief bill.

A third high priority item on any financial "to do" list is providing more resources for the FDIC, whose Chairman, Sheila Bair, has asked for them. Congress and the Administration (this one, or certainly the next) should enlarge the FDIC's line of credit with the Treasury. At a later point, the FDIC can repay any borrowings it may require from higher insurance assessments on the banks and thrifts whose deposits it insures.

Policy makers now have a bit more breathing room to figure out what to do with the two large housing "government-sponsored enterprises" (GSEs), Fannie Mae and Freddie Mac, because both are in "conservatorship" and continue to operate with federal guarantees and a pledge by the federal government to back the roughly $5 trillion in mortgages they hold or that back the mortgage-backed securities (MBS) they guarantee. The broad options include: (1) the return of Fannie and Freddie to the private sector, but much better regulated; (2) privatizing them in some fashion; (3) nationalizing them and having them become arms of a federal agency (as Fannie once was); or (4) gradually liquidating their portfolios. Regardless of which of these options policy makers eventually choose, it makes sense to find other, more direct and transparent ways of assisting home buyers of limited financial means than channeling such aid through the GSEs.

The next Administration, the Congress, and regulators also have more time to enact the necessary reforms for preventing a replay of what we have seen. They must act with deliberate haste – that is, promptly but with enough time to think through both the likely benefits and costs of the steps they consider, and only adopt those measures where the former outweigh the latter. We outline some of the options and our key recommendations, to this point, in the sections that follow.

4. www.treasury.gov/press/releases/reports/Blueprint.pdf

Know What Went Wrong Before Beginning to Fix Anything

There has been a "domino-like" character to the financial crisis that is now readily apparent to all:

- The bubble in home prices, fueled by the ready availability of credit, resulted in an underestimate of the risks of residential real estate;

- The peaking of residential home prices in 2006, combined with lax lending standards were followed by a very high rate of delinquencies on subprime mortgages in 2007 and a rising rate of delinquencies on prime mortgages[5];

- Losses thereafter on the complex "Collateralized Debt Obligations" (CDOs) that were backed by these mortgages;

- Increased liabilities by the many financial institutions (banks, investment banks, insurance companies, and hedge funds) that issued "credit default swaps" contracts (CDS) that insured the CDOs;

- Losses suffered by financial institutions that held CDOs and/or that issued CDS's;

- Cutbacks in credit extended by highly leveraged lenders that suffered these losses.

These events, individually and in combination, have led to the bear stock market, whose downward slide accelerated Monday September 15 through mid day Thursday the 18, after Lehman Brothers filed for bankruptcy and the Federal Reserve loaned AIG $85 billion to keep it afloat – although the market quickly recovered at the end of the week after the Administration's massive mortgage securities rescue initiative was announced.

So far, the financial turmoil on Wall Street has had a surprisingly modest impact on Main Street. Despite the crisis and the surge in commodity prices, the non-financial sector of the economy has continued to grow, spurred in significant part by a large growth in exports (fueled, in turn, by a steep decline in the dollar). Whether this pattern will continue — and specifically whether consumer spending will hold up in the face of the recent nerve-racking financial events and the steady climb in the unemployment rate (now over 6 percent) — is one of the large uncertainties confronting us all.

Likewise, in retrospect it is now relatively easy to see that much of this financial carnage, and thus any subsequent economic damage, could have been avoided:

- Had policy makers reined in the increasingly irresponsible subprime mortgage lending practices that were apparent earlier this decade — the proliferation of "no-doc" loans, often taken out with little or no equity from subprime borrowers, and frequently on adjustable terms with seductively attractive initial "teaser" interest rates, all on the widely held assumption that home prices would continue to rise — it is likely that this crisis would been largely, if not entirely, avoided. When there is a significant probability that an asset market is in a speculative bubble, it is time to tighten lending standards, not loosen them.

- Had Federal policymakers in both the Congress and the Administration not pressed so hard on "affordable housing goals" that encouraged lenders to extend and borrowers to take out loans that could not be reasonably serviced unless home prices continued to rise, and which Fannie and Freddie began to buy in large volumes

5. Past experience from regional downturns show that house price declines trigger mortgage defaults even for prime borrowers. See "*Making Sense of the Subprime Crisis*," by Andreas Lehnert and Paul Willen, paper presented at the Brookings Panel on Economic Activity, September 11, 2008.

in the last several years, Fannie and Freddie may have escaped the fate that has befallen them.

- Had the credit rating agencies whose stamps of approval were key to the sale of CDOs and other complex securities that later suffered losses been more transparent in how their ratings were provided and in the limited nature of the data on which they were made, it is likely that these securities would have been much more difficult to sell, and thus in turn, that subprime mortgages would not have been so easily originated.

- Had regulators done a better job monitoring the risk exposures of commercial banks, especially through their creation of off-balance entities known as "Structured Investment Vehicles" (SIVs), the market for CDOs would not have been so deep (the same is true for the state insurance regulators who oversaw the "monoline" insurers that insured CDOs and AIG, the nation's largest insurer, that issued them).

- Had policy makers not permitted investment banks to vastly increase their leverage so that they were far more exposed to failure when they suffered losses from their various investments, the previously independent investment banks may have been able to avoid their forced alliances with commercial banks (or, in the case, of Lehman, failure).

- And had financial institutions followed their own internal risk management guidelines, then it is possible that the current crisis would not be so deep and that the face of both of the commercial and investment banking industries would now not be so radically changed.[6]

Recognizing what went wrong is important in assessing what needs to be changed in the future. We do not plan to get into the blame game, nor is it productive for policy makers to do so (though we expect a certain amount of this during an election campaign). Instead, it is vital that those charged with fixing this mess draw on what is now widely known and agreed upon so as to develop appropriate reforms that would dramatically lower the risks and consequences of future financial crises, without chilling the financial innovation for which America's highly entrepreneurial financial sector has long been known. That is the approach we will follow in this project, and in the broad suggestions outlined next.

6. We do not, as some have argued, blame the Federal Reserve's low interest monetary policy earlier this decade for inflating the real estate bubble. An extraordinary influx of foreign funds – much of it from foreign central banks – kept long-term interest rates, or those most directly relevant for home finance, low throughout the past several years, despite substantial federal budget deficits and continued low rates of domestic saving. Had the Fed kept short term interest rates higher throughout this period, it is likely that the bubble in home prices would have been less pronounced, but economic growth would have suffered.

Principles To Guide More Permanent Reforms

The array of things that require fixing over the intermediate to long run can seem so daunting and unique that it can be paralyzing without having a sensible framework to guide the effort. There are two ways to bring structure to this process.

One way is to think of the time-line of events that led to the crisis and address reforms at each stage. This would mean new rules (not necessarily all statutory) for: mortgage origination; mortgage (and perhaps other asset) securitization; better oversight of and/or disclosure by credit ratings agencies; improved oversight of currently regulated financial institutions and possibly new federal safety and soundness and disclosure rules for other financial institutions (such as insurance companies, which are now regulated only at the state level; investment banks, whether standalone or affiliated with commercial banks; and hedge funds) that engaged in securitization and that ended up with the complex securities on their balance sheets.

Separately, policymakers will want to weigh in on how Fannie/Freddie should emerge, if at all, from conservatorship; on whether so-called "mark-to-market" accounting rules (requiring assets to be valued at their market prices even if the "market" for them are thinly or barely traded) that some have argued have aggravated the financial meltdown should be changed at all, and if so, how; and perhaps on the need to keep the SEC's rules governing short sales, a practice that some critics assert have accelerated the recent stock price declines, or whether stronger enforcement of existing laws against coordinated short selling and spreading false rumors is a more appropriate response.

A second way to structure and think about reform proposals is to ensure that they abide by certain fundamental principles. We suggest three, on which there seem to be a broad consensus (even though differences remain on the way in which these principles should be applied).

First, financial instruments and institutions should be more transparent.

One key problem with financial innovation in recent years has been that many of the securities and the financial institutions that issued or held them have been less than transparent. In addition, many borrowers, it seems, did not understand some of the key terms of the subprime mortgages they signed to finance the purchase of new homes or refinance their existing residences. 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.

As we know from many areas of life, self-interest is a powerful economic force. Good regulation harnesses that force. By increasing transparency — specifically rules improving and simplifying disclosures of financial instruments and by different financial institutions — we can give all parties better tools to monitor financial risk-taking themselves. As examples, consider the following:

- ***For mortgages:*** simpler disclosures, counseling in advance for subprime borrowers, and perhaps a default contract from which people could opt out; and further restrictions on the design of high-cost mortgage contracts, along the lines proposed by the Federal Reserve.

- ***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, especially credit default swaps:*** facilitate the formation of a clearinghouse, which should reduce counter-party risk; and to encourage the standardization of these contracts, impose higher capital requirements on CDS' that are customized.

Second, 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.

In recent years, the 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 it has greatly worsened the consequences when the bubble deflated.

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 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.

Still, these private responses should be accompanied by regulatory changes. We believe the following steps have much to recommend them:

- ***For commercial banks:*** capital requirements for off-balance-sheet liabilities and required issuance of uninsured subordinated debt.

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

- ***For bond insurers:*** higher capital requirements.

- ***For insurers:*** an optional system of federal chartering and regulation, aimed primarily at protecting their safety and soundness.

Third, financial institutions should be supervised more effectively, with greater regard for systemic risks.

Government oversight of risk-taking by financial institutions does not take the form solely of laws and regulations. Prudential supervision is another crucial component of public policy. In recent years, supervision did not adequately monitor or constrain mistakes being made by financial institutions, and we must improve supervision going forward.

An immediate priority is for the agencies with current regulatory authority to do a better job of carrying out the responsibilities they already have. In this regard, special attention must be paid to ensuring that financial institutions do not have off-balance sheet entities that, in an emergency, must be pulled back on the balance sheet; to doing a better job of overseeing institutions' risk management practices; and to more closely supervise underwriting standards for new products.

In addition, when regulators monitored the safety and soundness of individual institutions, they did not take into account adequately the way in which a given institution might be contributing to systemic risk. Looked at in isolation, a financial institution may seem to have adequate reserves, liquidity and solvency. But the assets of this institution may be the liabilities of another, and this pattern may be repeated down the line for several interconnected institutions. In this case, problems in one institution can cause a cascade of problems through the system.[7] As the global capital market has become more integrated this issue has become more important, indeed such interactions were an important ingredient in the current crisis. Under the Treasury Blue Print, the Federal Reserve has been charged with monitoring systemic risk and it will need to develop powerful new tools to provide this supervision and work with other regulatory agencies.

7. See Stephen Morris and Hyun Song Shin, "Financial Regulation in a System Context," paper presented at the Brookings Panel on Economic Activity, September 11, 2008, for an analysis of this issue.

Act In Our Own Interest, While Consulting with Other Countries

Finally, recent events have dramatically illustrated the extent to which the financial system is now truly global in nature: subprime mortgages originated throughout the United States found their way, through the development and sale of complex mortgage securities, on the balance sheets of financial institutions around the world.

A number of global or multinational bodies — the Basle Committee (for banks), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), and the International Accounting Standards Board (IASB) — are in place to coordinate regulatory oversight of financial markets and institutions for precisely this reason. Markets and institutions are linked across borders, and thus effective regulation requires, at a minimum, cooperation by regulators from different countries. In some areas, such as bank capital regulation, great effort has gone into harmonizing the rules, not only to help ensure safety and soundness but ostensibly to "level the playing field" so that no country's banks have an "unfair" competitive advantage relative to those from other countries.

It is important going forward to continue working with and consulting these various multinational bodies and the financial experts within their member governments. It is the U.S. financial system, after all, that is now on trial in the eyes of the world, and it is important at least for this reason, and others, for our policy makers to reach out to seek advice from other countries whose financial institutions and economies have suffered on account of the mistakes made here.

That said, waiting to gain international consensus can take time: witness the roughly 10 years it took to gain agreement on a revision to bank capital standards, which by the time that occurred, the current financial crisis was upon us, triggering yet another reexamination of those standards. In addition, international politics have a way of affecting international standards, to the potential detriment of our own interests.

Accordingly, we would counsel policy makers here to proceed expeditiously, but deliberately, to fix the problems with our financial system that are very much home-made. We should continue to take part in the discussions of these issues in the appropriate international forums, but we should not wait for international consensus to develop before we act.

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