

MAKE
MARKETS
BE
MARKETS

ROOSEVELT
INSTITUTE

**PROJECT ON
GLOBAL FINANCE**

STEP 1: RESTORING THE INTEGRITY
OF THE US FINANCIAL SYSTEM

These are unprecedented and unusual times. . . the failure to solve our troubles may degenerate into unreasoning radicalism. . . Wild radicalism has made few converts, and the greatest tribute that I can pay to my countrymen is that in these days of crushing want there persists an orderly and hopeful spirit on the part of millions of our people who have suffered so much. To fail to offer them a new chance is not only to betray their hopes but to misunderstand their patience. To meet by reaction that danger of radicalism is to invite disaster. Reaction is no barrier to the radical. It is a challenge, a provocation. The way to meet that danger is to offer a workable program of reconstruction. . . This, and this only, is a proper protection against blind reaction on the one hand and an improvised, hit-or-miss, irresponsible opportunism on the other. There are two ways of viewing the Government's duty in matters affecting economic and social life. The first sees to it that a favored few are helped and hopes that some of their prosperity will leak through, sift through, to labor, to the farmer, to the small business man. . . This is no time for fear, for reaction or for timidity. . . Now it is inevitable - and the choice is that of the times - that the main issue should revolve about the clear fact of our economic condition. . . Let us look a little at the recent history and the simple economics, the kind of economics that you and I and the average man and woman talk. . . Enormous corporate surpluses piled up - the most stupendous in history. Where, under the spell of delirious speculation, did those surpluses go? . . . They went chiefly into the call-money market of Wall Street, either directly by the corporations, or indirectly through the banks. Those are the facts. Why blink at them? Then came the crash. You know the story. . . purchasing power dried up; banks became frightened. . . Those who had money were afraid to part

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In 2009, the Roosevelt Institute launched a policy center focused on the development and promotion of some of the most innovative, rigorous voices and ideas inspired by the courage and progressive values that Franklin and Eleanor Roosevelt brought to the twentieth century. The center's first projects focus on global finance and the architecture of a 21st century economy. This report on restoring the integrity of the U.S. financial markets is the result of research and discussion among some of the country's leading financiers, market experts, academics and former regulators.

VOLUME EDITORS

Robert Johnson

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The Roosevelt Institute is a nonpartisan 501(c)3 organization. The views expressed in this volume are those of the authors and do not necessarily reflect the views of the Institute, its officers, or its directors.

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The volume editors would like to acknowledge the contributions of Madeleine Ehrlich, Caitlin Howarth, Danielle Mazzeo, and Lynn Parramore.

“We have had to struggle with the old enemies of peace
- business and financial monopoly, speculation, reckless
banking, class antagonism, sectionalism, war profiteering.”

I wish these words, spoken in 1936 by my grandfather Franklin D. Roosevelt, were not as true today as then. Yet over the past eighteen months this nation has faced a financial crisis second only to the Great Depression. It is a crisis that in many ways was predictable and preventable - one that experts had seen on the horizon for years. In the end, like the market crash that fueled the Great Depression, the current financial crisis may have been inevitable, fueled by systemic flaws that require systematic repair.

By many accounts, we did not lack the ability to foresee the looming crisis. Rather, too many of us lost sight of the need to guard against it. We lacked some of the courage and commitments that my grandparents - both of them - brought to the last century, commitments that might have made us question the sources of dizzying profits for a few and the decay of security and prosperity for the many.

We can continue on this course and attempt to endure the next crisis. Or now, in the breathing space between crises, we can think critically about the path ahead. I am pleased that the Institute that is named for my grandparents and inspired by their progressive values is helping to chart this latter course. In this volume, the Institute compiles expertise from some of the country's leading scholars and practitioners to offer a reasonable blueprint for restoring the integrity of the U.S. financial system.

During his first term as president, my grandfather remarked that he hoped that in his administration, the forces of selfishness and of lust for power had met their match. They may have then, but unfortunately, the struggle continues. I hope the ideas in this volume will make a productive contribution in the days ahead.


CO-CHAIR, BOARD OF DIRECTORS

The Roosevelt Institute launched a new policy center soon after I became president in 2009. The center is focused on developing and promoting some of the most rigorous, innovative ideas and the leaders who are their strongest proponents – all with an eye to shaping the public dialogue in ways that carry forward the courageous spirit and progressive values that the Roosevelts brought to the last century.

We began our work with a focus on the crisis in the financial sector and its effects on the broader economy. President Roosevelt has an exceptional legacy of creating effective financial market regulation in the 1930s – rules that contributed to relatively stable financial markets for more than fifty years, until conservatives began the process of dismantling them in the 1980s. Precisely because it was an area that enjoyed relative stability for many decades, “non-conservatives” – for lack of a better term: all those who believe we need rules both of and for the game – had developed relatively little policy capacity until the financial collapse occurred. Today, the collapse has become the unfortunate catalyst in reinvigorating policy work on the economic principles first articulated during the Depression era, principles that proved that rules beget prosperity.

Under the leadership of Nobel Prize winning economist Joe Stiglitz and Rob Johnson, former chief economist to the Senate banking committee, we have convened top scholars, practitioners, and opinion leaders for many weeks to discuss and debate ideas for restoring health to the financial system. This volume is a product of that work. I want to thank each of the authors who have contributed their time and ideas to the chapters.

In the months ahead, the Roosevelt Institute will continue to engage the challenges in the financial sector and questions concerning the future of the American economy, and we will broaden our focus to additional subjects in need of new leadership and ideas.



PRESIDENT AND CEO

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INTRODUCTION

MAKE MARKETS BE MARKETS

Robert Johnson

Eighteen months after the most devastating financial crisis since the Great Depression, our financial system remains critically flawed. The United States has not yet enacted the financial reforms necessary to repair the broken financial system.¹

We have a financial system that continues to be sustained by taxpayers through the fiscal side door of the Federal Reserve's balance sheet. All legislative proposals offered by the Administration, House and Senate fall far short of what is needed for proper reform. Independent experts across the political spectrum have clearly identified the dangers of large complex financial institutions that are intertwined through the proliferation of derivative instruments. Those experts have also prescribed remedies that are concise, clear and well developed. Many of the fault lines in the current system and their remedies were well known long before this latest crisis unfolded.

The crisis of 2008 was predictable. Unless we go far beyond current legislative proposals the next crisis is inevitable.

The structure of our current financial markets does not reflect the critical market principles that once allowed our economy to flourish—principles like transparency, competition, and free flow of information. And it has not been subject to the most important principle of all—the opportunity for market participants to fail. We all know the result. Financial sector CEOs have relied on taxpayer support. They have benefitted from express taxpayer bailouts as well as secret “back door” deals. They continue to lead companies that seem to make profit but actually only thrive because of government subsidies and taxpayer support.

Make Markets Be Markets: Restoring the Integrity of the U.S. Financial System is the result of months of discussions among the country's leading financiers, market experts, academics and former regulators. These discussions, on issues ranging from ‘theory failures’ to ‘regulatory incentives,’ have culminated in the development of a concrete plan for a financial system that can manage the flow of capital, price risk appropriately, reduce fraud and collusion, protect taxpayers, and provide liquidity—all without compromising innovation or stability.

The purpose of this report is to present a comprehensive plan for what must be done to fix our broken financial system. It provides a set of recommendations that together serve to prevent, detect, and credibly resolve financial crises. Making markets work as a system is the focus—emphasizing transparency, competition, and the important discipline of failure. The goal is to restore the integrity of the market system with a realistic, rather than romantic, perspective on the role that government must play in the making and enforcing of the laws and regulations that are essential support for the market system.

Without the reforms outlined in this report, we cannot restore confidence in the U.S. financial markets, in the role of New York as an international financial center, and in the continuing use of the dollar as the primary reserve currency of the world economy. Ultimately we cannot ensure our national budgetary soundness, because we cannot rule out the wasteful and unnecessary budget burden of another crisis and bailout. If unaddressed, we will likely spiral into the amplifying “doom cycle” described by Simon Johnson in the first chapter.

Topics are addressed in the spirit of putting the markets back on sound footing. They include: the reform of GSEs dependent on an unhealthy open spigot of government capital and guarantees; the reform of ratings agencies; the importance of regulatory incentives in determining rules versus discretion in the design of the government’s oversight role; the establishment of a strong consumer protection system that will stop toxic instruments and incomprehensible documents from fouling our economic bloodstream; the reform of the shadow banking system that exposed our financial system to runs; reform of the securitization process through which over 50 percent of capital flows were intermediated in the years prior to the crisis but which now lies largely dormant; the ending of deceptive and damaging off balance sheet practices that were revealed and not reformed by the Enron scandal; the move away from the dark mark to model world of OTC markets to a world in which well-designed derivatives function in transparent, properly-cleared and settled markets where information flows freely; and finally, perhaps most importantly, the ability to credibly resolve Large Complex Financial Institutions whose current government guarantee serves as a illegitimate burden on the American people and a moral stain on the legitimacy of the market system.

This set of topics by no means exhausts the terrain of important reforms. Other critical themes will be developed as part of this project in subsequent reports, including the definition of the appropriate scope and scale of guarantees of financial institution liabilities; mortgage foreclosure modification; the governance of the central bank and its role in financial resolution; the registration and systemic monitoring of the aggregated positions of hedge funds and private equity funds; the role of executive incentives and corporate governance; and the important role of venture capital and small capitalization equity markets in transforming the structure of the economy and providing new paths to employment.

The purpose of setting out the recommendations put forth in the present report is twofold. First, they provide a roadmap for financial reform and as such can help advise efforts already underway. Second, they provide a critical litmus test for citizens and the media can use to measure the progress of our political system. This report defines the minimum we must do before we can restore the integrity of the U.S. financial markets. By defining that threshold of reform, we also illuminate the vast gap between what is happening in Washington D.C. and what reasonable, un-encumbered experts believe is necessary.

Our government leaders have shown little capacity to fix the flaws in our market system. Admittedly the issues involved are complex, even for finance professionals. Yet the complexity of the subject is no reason to defer to those who cloak themselves in a mantle of expertise in order to clandestinely advance their gross self-interest.

The pressure from industry groups is enormous – and the money at stake for the Large Complex Financial Institutions is measured in billions of dollars of earnings each year. They have powerful incentives to impede reform at every turn – and are willing to invest enormous sums to block reform and keep their dangerous money making structures alive. Forces that protect dysfunctional businesses, rather than ensuring competitive markets, are rampant. As University of Chicago Professor Luigi Zingales put it, “most lobbying is pro-business, in the sense that it promotes interests of existing business, not pro-market, in the sense of fostering truly free and open competition”.^{2,3} The \$400 million dollars financial institutions spent on lobbying last year, and their successful effort to stymie reform is convincing evidence of this.

When businesses rely on government bailouts instead of on innovation and investment, they are weakened. Once upon a time, the American auto industry was the best in the world. But years of using political muscle instead of intellectual or creative muscle – relying on lobbying rather than R&D and productivity improvements – took its toll. Wall Street despised manufacturing protectionism. Yet now Wall Street is seeking protectionism of its own. It is trying desperately to maintain an opaque and unsustainable system that imposes heavy costs on the rest of society. The leaders of these institutions are hiding behind the skirts of the American taxpayer.

The toxic side effects for society of Wall Street protectionism are substantial. Detroit’s automakers embraced government for protection, and they ended up bankrupt. Ironically, it will require the tough love of proper reform from Washington and the American people to save Wall Street from going bankrupt a second time.

With the reforms suggested in this volume, another crisis is preventable. Without them, another crisis – a bigger crisis that weakens both our financial sector and our larger economy – is more than predictable, it is inevitable.

ENDNOTES

1. It may well be that the improvisation by the Federal Reserve was necessary given the ill-formed regulatory system and resolution structures that existed at the onset of the financial crisis. At the same time the massive fiscal role that the Federal Reserve has played, the extensive and inconsistent use of their Section 13(3) powers to bail out institutions that were not banks at the end of 2007, and the unacceptable structure of Federal Reserve governance, particularly the governance of the New York Federal Reserve Bank which is thrust into the primary fiscal/bailout role, combine to reveal a resolution process that is badly designed and crying out for reform. Public confidence in the Federal Reserve has plummeted since the onset of the crisis. For more on this theme and

Gallup poll data see, “Unmet Duties in Managing Financial Safety Nets” by Dr. Edward J. Kane, February 10, 2010. Available at <http://www2.bc.edu/~kaneeb/>

2. Capitalism After the Crisis, *National Affairs*, Issue 1 Fall 2009. <http://www.nationalaffairs.com/publications/detail/capitalism-after-the-crisis>
3. See the illuminating collection of writings on the history of struggles between business interests and the politics of American society contained in Thomas Ferguson’s extraordinary book entitled *Golden Rule*, University of Chicago Press, 1995.

ROBERT JOHNSON

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The views expressed in this paper are those of the author and do not necessarily reflect the positions of the Roosevelt Institute, its officers, or its directors.

THE DOOM CYCLE¹

Peter Boone and Simon Johnson

We have let an unsustainable and crazy ‘doomsday cycle’ infiltrate our economic system.² This cycle has several simple stages. At the start, creditors and depositors provide banks with cheap funding in the expectation that if things go very wrong, our central banks and fiscal authorities will effectively bail them out. This is the “boom” phase – leading inevitably to an overexpansion of credit, a traumatic market, corporate, and household “bust” and, for as long as we can afford it, to huge bailouts roughly along the lines we saw in 2008-09.

This cycle will not run forever. One day soon, we’ll have the boom and bust phases, but when we try the usual bailouts, they won’t work. The destructive power of the down-cycle will overwhelm the restorative ability of the government, just like it did in 1929-31, when both the financial shock and the government capacity to respond were on a much smaller scale. The result, presumably, will be something that looks and feels very much like a Second Great Depression.

RISKY BUSINESS

At the heart of this problem are today’s mega-banks such as Citigroup and Goldman Sachs – and many others in this past cycle – which use borrowed funds to take large risks, with the aim of providing dividends to shareholders and bonuses to management. Through direct subsidies (such as deposit insurance) and indirect support (such as central bank bailouts, including both special credit programs and cheap credit), we encourage our banking system to ignore large, socially harmful ‘tail risks’ – those risks where there is a small chance of calamitous collapse. As far as banks are concerned, they can walk away and let the state clean it up. This used to be known, somewhat light heartedly, as the “Greenspan put”, but there is nothing funny about our current predicament – which has become even worse since Greenspan left office.

And do not make the mistake of thinking that the costs of this “put” are entirely monetary, i.e., off balance-sheet as far as the fiscal authority is concerned. Privately held debt as a percent of GDP in the US will increase by about 40 percentage points as a direct result of the measures – including automatic stabilizers, discretionary stimulus, and direct bailout costs – that the federal government was forced to take. This moves us into dangerous territory with regard to our overall debt level, particularly given the lack of a credible medium-term framework for debt sustainability, making us more vulnerable to financial collapse in the future – a number of European countries, for example, have already something like a “debt limit” beyond which they cannot use fiscal stimulus under any circumstances. We are heading in the same direction.

Irresponsible risk-taking by the biggest players in our financial sector has placed us in fiscal jeopardy. But that is not the worst of it. We haven’t fixed – and, in fact, are not seriously addressing, the incentive problems of huge banks. They

will make similar “mistakes” again because, from their perspective, these are not mistakes – these are legitimate ways to maximize returns (as they see them) “over the cycle”.

The bankers, to be honest, are just doing their jobs – to make money. Regulators are supposed to prevent dangerous risk-taking. Adair Turner, chairman of the UK Financial Services Authority, is calling for more radical change than most regulators. In this regard, he is on the same page as Paul Volcker, former chairman of the Federal Reserve Board. But these are lonely voices.

Many bankers and policy-makers do well – financially or in terms of career advancement – during the collapse that they helped to create. They have very little personal or professional incentive to break this cycle, at least until it breaks the economy.

In the US and Western Europe today, banks wield substantial political and financial power, and because the system has become remarkably complex, regulators are effectively captured. The extent of regulatory failure ahead of the current crisis was mind-boggling. Prominent banks, including Northern Rock in the UK, Lehman Brothers in the US, and Deutsche Bank in Germany, convinced regulators that they could hold low amounts of capital against large and risky asset portfolios. The whole banking system built up many trillions of dollars in exposures to derivatives. This meant that when one large bank or quasi-bank failed, it could bring down the whole system.

Given the inability of our political and social systems to handle the hardship that would follow economic collapse, we rely on our central banks to cut interest rates and direct credits so as to bail out the loss-makers. While the faces tend to change, each central bank and government operates similarly. This time, it was Ben Bernanke and Tim Geithner who oversaw policy as the bubble was inflating. These same men are now designing our “rescue”.

When the bailout is done, we start all over again. This has been the pattern in many developed countries since the mid-1970s – a date that coincides with significant macroeconomic and regulatory change, including the end of the Bretton Woods fixed exchange rate systems, reduced capital controls in rich countries, and the beginning of 30 years of regulatory easing.

The real danger is that as this cycle continues, the scale of the problem is getting bigger. If each cycle requires greater and greater public intervention, we will surely eventually collapse – it is highly unlikely that we will always be able to counteract (growing) financial shocks with appropriately sized monetary and fiscal policy responses.

To stop the doomsday cycle, we need far greater reform than is currently under discussion. The headline-grabbing actions of Gordon Brown and Alistair Darling, calling for financial transactions taxes and a one-year super tax on bonuses – or

Barack Obama and Paul Volcker calling for limits on proprietary trading – have no impact on the fundamental problems in our system. Indeed, they are potentially harmful to the extent that they mislead taxpayers who want real solutions.

NEW POLICIES NEEDED

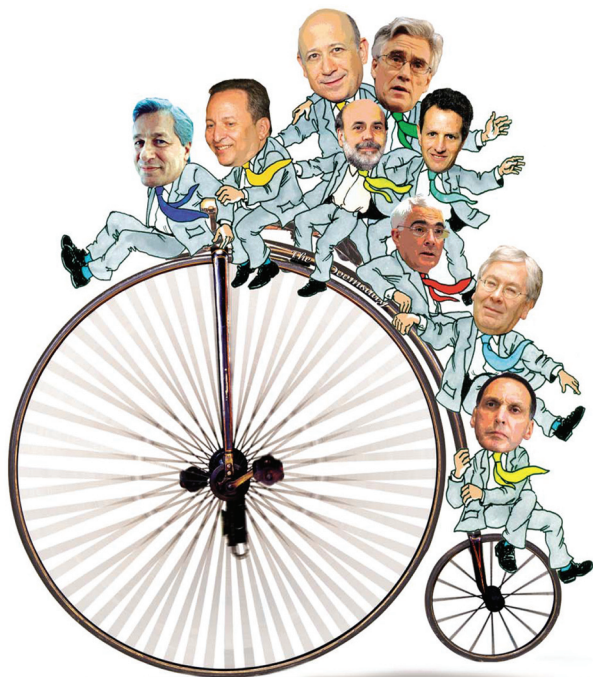
We need quite different and much more focused policies. These policies must be implemented across the G-20, with international coordination and monitoring – the US, the UK, and others with financial capabilities can take the lead on this front. Otherwise, financial services will move to the least regulated parts of the world, and it will be much more difficult for each country to maintain a tough stance

So what should be done? First, consider the regulatory problem: there are two broad ways to view past regulatory failures that have brought us to such a dangerous point. One is to argue it is a mistake that can be corrected through better rules.

That has been the path of successive Basel committees, which are now designing comprehensive new rules to ensure greater liquidity at banks and to close past loopholes that permitted banks to reduce their core capital. We both worked for many years in formerly communist countries, and this project reminds us of central planners' attempts to rescue their systems with additional regulations until it became all too apparent that collapse was imminent.

In our view, the long-term failure of regulation to check financial collapses reflects deep political difficulties in creating regulation. The banks have the money, they have the best lawyers and they have the funds to finance the political system. Politicians rarely want strong regulators – except after a major collapse (like the 1930s).

There are also big operational problems. For example, how should regulators decide the risk capital that should be allocated to new and arcane derivatives, which banks claim will reduce risk? When faced with rooms full of pa-



pers describing new instruments, and bank-hired experts bearing risk assessments, regulators will always be at a disadvantage.

The operational difficulties are further complicated by the intellectual undercurrents. When the economy is booming, driven by more leveraged bets, there is a tendency for the academic world to provide theories that justify status quo policies. This is clear from the growth of efficient markets theories, which infiltrated regulators' decision-making during the boom that preceded the most recent crisis.

No wonder that Tim Geithner, while president of the Federal Reserve Bank of New York, or Alan Greenspan and Ben Bernanke, as Fed chairman, did little to arrest the rapid growth of derivatives and off-balance sheet assets. It requires a strong leap of faith to believe that our regulatory system will never again be captured or corrupted. The fact that it has spectacularly failed to limit costly risk should be no surprise. In our view, the new regulations proposed for Basel 3 will fail, just as Basel 1 and Basel 2 have failed.

Such detailed proposals sound smart because they are correcting egregious errors of the past. But new errors will surface over the next five to ten years, and these will be precisely where loopholes remain, and where the system gradually becomes corrupted, again.

The best route towards creating a safer system is to have very large and robust capital requirements, which are legislated and difficult to circumvent or revise. If we triple core capital at major banks to 15-25% of assets – putting capital-asset ratios back to where they were in the United States before the formation of the Federal Reserve in 1913 – and err on the side of requiring too much capital for derivatives and other complicated financial structures, we will create a much safer system with less scope for 'gaming' the rules.

Once shareholders have a serious amount of funds at risk, relative to the winnings they would make from gambling, they will be less likely to gamble in a reckless manner. This will make the job of regulators far easier, and make it more likely our current regulatory system could work.

Second, we need to make the individuals who are part of any failed system expect large losses when their gambles fail and public money is required to bail out the system. While many executives at bailed-out institutions lost large amounts of money, they remain very wealthy.

Some people have clearly become winners from the crisis. Alistair Darling appointed Win Bischoff, a top executive at Citigroup in the run-up to its spectacular failure, to be chairman of Lloyds. Vikram Pandit sold his hedge fund to Citigroup, who then wrote off most of the cost as a loss, but Pandit was soon named their CEO. Jamie Dimon and Lloyd Blankfein, CEOs at JP Morgan and Goldman Sachs respectively, are outright winners from this process, despite the

fact that each of their banks also received federal bailouts – and they agreed to limit their bonuses for 2009.

Goldman Sachs was lucky to gain access to the Fed's 'discount window'; its conversion to a bank holding company averted potential collapse. We must stop sending the message to our bankers that they can win on the rise and also survive the downside. This requires legislation that recoups past earnings and bonuses from employees of banks that require bailouts.

Third, we need our leading fiscal and monetary policy-makers to admit their role in generating this doomsday cycle through successive bailouts. They need to develop solutions so that their institutions can credibly stop this cycle. The problem is simple: most financial institutions today have now proven too big to fail, as our policy-makers have bailed them all out.

The rules need to change so that creditors do not expect another bailout when the next crisis happens. There is some encouraging progress with plans for 'living wills' and measures to reduce the interdependency of financial institutions. But the litmus test for this will be when our leading policy-makers start calling for the break-up of large financial institutions and permanent robust limits on their size relative to the economy in the future.

Smaller institutions are naturally easier to let fail, and this will make creditors nervous when lending to them, so we can have more confidence that creditors will not lend to highly risky small institutions. There are feasible ways of doing this: for example, we could impose rising capital requirements on large institutions over the next five years, thus encouraging them to develop orderly plans to break up and shrink their banks.

DOOM CYCLE CONTINUES

So where are we going with our current reforms? It is now obvious that risk-taking at banks will soon be larger than ever. Central banks and governments around the world have proved (once again) that they are willing to bail out banks at enormous public cost when things go wrong. Markets are now again providing very cheap loans to banks, with the comfort that the state will bail them out.

Today, Bank of America and the Royal Bank of Scotland are each priced to have just 0.5% annual risk of default above their sovereigns during the next five years in credit markets. This is a remarkably low implied risk, considering that both banks were near to collapse just a few months ago. Creditors are clearly very confident that they will be bailed out again if necessary. Indeed, they are more comfortable lending to large risky banks than to many successful corporations.

There is no doubt that the regulatory environment is going to be tougher for the next few years. But nothing has changed to make us believe the regulatory system will succeed this time, when it has failed so enormously – and repeat-

edly – in the recent past. To bring about the dramatic change that is needed also requires international cooperation and consistency.

Many of our current policy-makers – including Ben Bernanke – are the same ones that inflated the last bubble. So we know with great confidence that they are the types that will bail us out each time things go wrong. They are all currently on course for seeding our next rise and collapse: cheap rates and credit, with large moral hazard, are the initial stages of each cycle. Very few of these people, apart perhaps from Mervyn King (and Paul Volcker, if he is really back in a more active role), appear prepared to recognize their past role in creating our current problems and then to discuss resolutely how to change it.

The danger this system poses is clear. With our financial system now well-oiled to take on very large risk once again, and to gamble excessively, can we be sure that we can continue this cycle of bailing out eventual failures? At what point will the costs be so large that both fiscal and monetary policies are simply incapable of stopping the collapse?

In 2008-09, we came remarkably close to another Great Depression. Next time, we may not be so “lucky”. The threat of the doomsday cycle remains strong and growing.

Over the last three decades, the US financial system has tripled in size, as measured by total credit relative to GDP. Each time the system runs into problems, the Federal Reserve quickly lowers interest rates to revive it. These crises appear to be getting worse and worse – and their impact is increasingly global. Not only are interest rates near zero around the world, but many countries are on fiscal trajectories that require major changes to avoid eventual financial collapse.

What will happen when the next shock hits? We may be nearing the stage where the answer will be – just as it was in the Great Depression – a calamitous global collapse.

ENDNOTES

1. This chapter is based on “The doomsday cycle,” which appeared in the London School of Economics’ “Centerpiece,” published by the Center for Economic Performance, Winter 2009/10 (<http://cep.lse.ac.uk/centrepiece/>). This material is used here with permission.
2. Andrew Haldane, executive director for financial stability at the Bank of England, has written an excellent paper describing a similar idea – the ‘doom loop’ (<http://www.bankofengland.co.uk/publications/speeches/2009/speech409.pdf>).

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Peter and Simon write for The Baseline Scenario, a leading economics blog (<http://baselinescenario.com>), and are co-authors of 'Our Next Financial Crisis', published in *The New Republic* in September 2009 (<http://www.tnr.com/article/economy/the-next-financial-crisis>) and "Shooting Banks" published in *The New Republic* in February 2010.

The views expressed in this paper are those of the authors and do not necessarily reflect the positions of the Roosevelt Institute, its officers, or its directors.

THE GIANTS FALL

ELIMINATING FANNIE MAE & FREDDIE MAC

Raj Date

In the three full years since the first emergence of the credit crisis, market participants and policymakers have offered a variety of competing narratives regarding its genesis. The commonsense perspective of nearly all those competing narratives is that the U.S. residential mortgage market was at the center of global financial market turbulence.

Despite that seeming consensus, policymakers remain undecided as to the fate of the largest (and to taxpayers, the most costly) participants in the U.S. mortgage business: the government sponsored enterprises, Fannie Mae and Freddie Mac (together, the “GSEs”).¹

Fannie and Freddie’s central function, guarantying mortgage credit through government-sponsored private firms, is fatally flawed. Although they arguably provide other systemic benefits beyond credit guaranties (liquidity support, interest rate risk absorption), those benefits could be more transparently and efficiently delivered through other means. As a result, there is no logically defensible reason for the GSEs’ survival. They should be eliminated.

EVALUATING GSE FUNCTIONS

The GSEs’ mandated mission is to provide liquidity, stability, and affordability to the U.S. residential mortgage market.² In practical terms, that mission has been executed through two business lines: guaranteeing MBS issues; and holding mortgage and MBS portfolios. Those lines of business, in turn, serve three broad functions: (1) the extension of credit; (2) the provision of liquidity; and (3) the absorption of interest rate risk. (See Figure 1)

EXTEND CREDIT

The first of the GSE functions, the extension of credit guarantees on mortgage pools, is at the very core of the GSEs’ purpose and strategy. And that core activity is irretrievably flawed.

In concept, Fannie and Freddie are meant to enable, through their secondary market operations, primary market credit extension to borrowers that otherwise would not qualify.³ Of course, the GSEs do not intend to lose money through credit operations, so they can only logically achieve their credit goals if at least one of two conditions are true: (1) the GSEs can make otherwise non-economic credit risks viable because they enjoy a lower cost of capital, or (2) the GSEs, owing to scale, longevity, and sophistication, are superior to the private market as underwriters of credit risk. (See Figure 2)

FIGURE 1

GSE LINES OF BUSINESS AND FUNCTIONS

GUARANTY BUSINESS

- What is it?
 - The “core” business
 - Providing guaranty of principal and interest payments
- How do they make money?
 - Guarantee fee (‘G fee’) in excess of net credit losses
- What could go wrong?
 - Credit risk



**EXTEND
CREDIT**



**STABILIZE
LIQUIDITY**



PORTFOLIO BUSINESS

- What is it?
 - The “growth” business
 - Borrowing in capital markets to buy loans, GSE MBS, or private label MBS
- How do they make money?
 - Spread between asset yield and GSE funding costs
- What could go wrong?
 - Credit risk
 - Rate risk (prepayment, extension)
 - Liquidity risk
 - Counter-party risk (derivatives counter-parties)



**ABSORB
RATE
RISK**

Source: Fannie Mae; Freddie Mac; Cambridge Winter Center

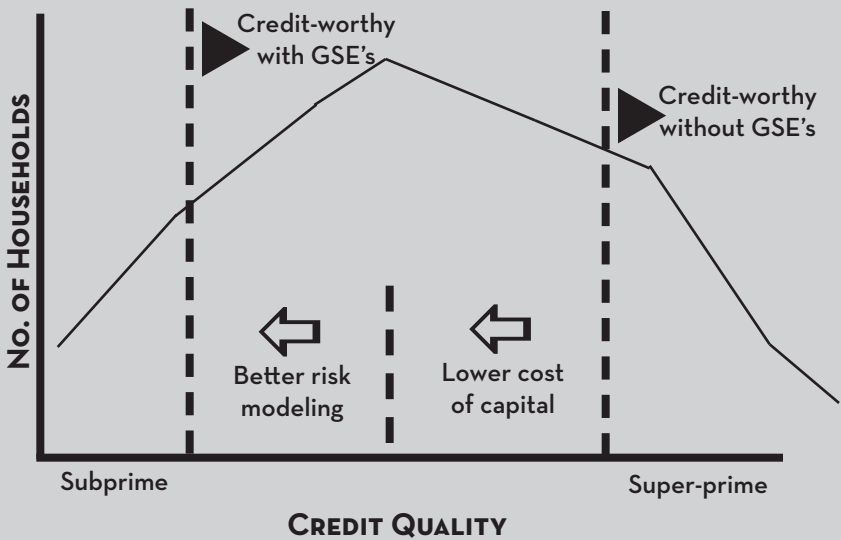
The first of those conditions is almost certainly true, but the second has proved false — so false, in fact, that the waywardness of the GSEs’ poor credit decisions has overwhelmed the advantage of their low cost of capital. It would appear that Fannie and Freddie’s realized losses on credit extended at the end of the housing boom (particularly 2006 and 2007) will be some 10 to 20 times worse than they had originally forecasted.

AFFORDABILITY MISSION

The GSEs, by charter, are intended to facilitate mortgage finance to lower-income homeowners, and to traditionally under-served communities. Given that, it is tempting to ascribe the GSEs’ disastrous credit performance to that “affordability” aspect of their mission. After all, the GSEs’ large-scale purchases of subprime private-label MBS were motivated in large measure by a Congressional mandate to promote homeownership rates. Even now, between them, Fannie and Freddie hold roughly \$100 billion in private-label subprime securities in their portfolios.⁴

FIGURE 2

CONCEPTUAL IMPACT OF GSEs ON CREDIT AVAILABILITY



Source: Cambridge Winter Center

But the affordability mission does not explain the vast majority of the GSEs' credit woes. (See Figure 3)

The \$100 billion of subprime securities in portfolio, while astonishing in nominal terms, is roughly 2% of the combined firms' \$5 trillion credit exposure. And within the guaranty business, subprime exposure is actually quite modest. At Freddie, for example, only 4% of the single-family mortgage credit book is tied to borrowers with FICO scores below 620.

Moreover, the very worst performing GSE loans (that is, the loans where losses are the greatest multiple of original forecasts) were made to prime borrowers, not subprime. Again using Freddie as an example, both the "Alt-A" and "Interest Only" portfolios are already facing serious delinquencies of 11% and 16%, respectively, despite having solidly prime average borrower FICO scores of 722 and 720.⁵ These were market share-driven loans made to people with good credit; they were not mission-driven loans made to people with bad credit.

Put simply, the subprime fraction of the GSEs' credit exposure is too small, and the GSEs' overall credit deterioration too large, to pin their woes on the affordability mission alone. Merely tweaking that mission, therefore, will not remedy the GSEs' ills. The problem is more fundamental.

LACK OF DEBT MARKET DISCIPLINE

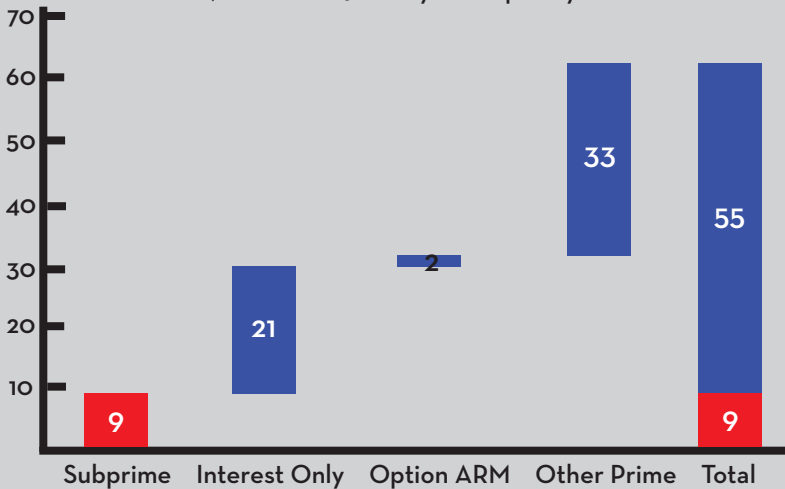
Fannie and Freddie's credit-decisioning processes, in large measure, rest on quantitative credit models. Such models have real benefits: they are reliably free of the primary market's sometimes checkered fair lending practices; they are efficient and scalable; and they take advantage of the GSEs' size and ability to gather loan-level performance data across the market.

But, as the crisis has made painfully clear, model-based credit decisioning has its drawbacks. Most importantly, backwards-looking, data-driven credit models are subject to a pro-cyclical bias. In other words, because most credit models rely primarily on historical performance data, they will tend to generate the most optimistic predictions at precisely the wrong time – at the end of a long period of low credit losses. That bias, combined with the asymmetric risk bias of the management and board of any privately owned, highly leveraged firm, inevitably creates an outsized risk appetite during benign parts of the credit cycle.⁶

In an ideal market, that risk appetite would be checked by fixed income investors, who stand to lose if management is too aggressive over time. Such debt market discipline is crucial: in any highly leveraged system of credit allocation, debt markets serve as the most important line of defense against the positive risk biases of customers, management teams, and boards of directors. As the experience of this financial crisis indicates, the ability of regulators alone – that is, without debt investor assistance – to hold back credit bubbles is debatable at best. (See Figure 4)

FIGURE 3

FREDDIE MAC SERIOUS DELINQUENCY, 3Q09 \$ Billions of 90+ Day Delinquency UPB



Note: UPB is 'unpaid principal balance'; subprime is all FICO<620; I/O, Option ARM, and Other Prime include estimated FICO>620 components only.

prime subprime

Source: Cambridge Winter Center

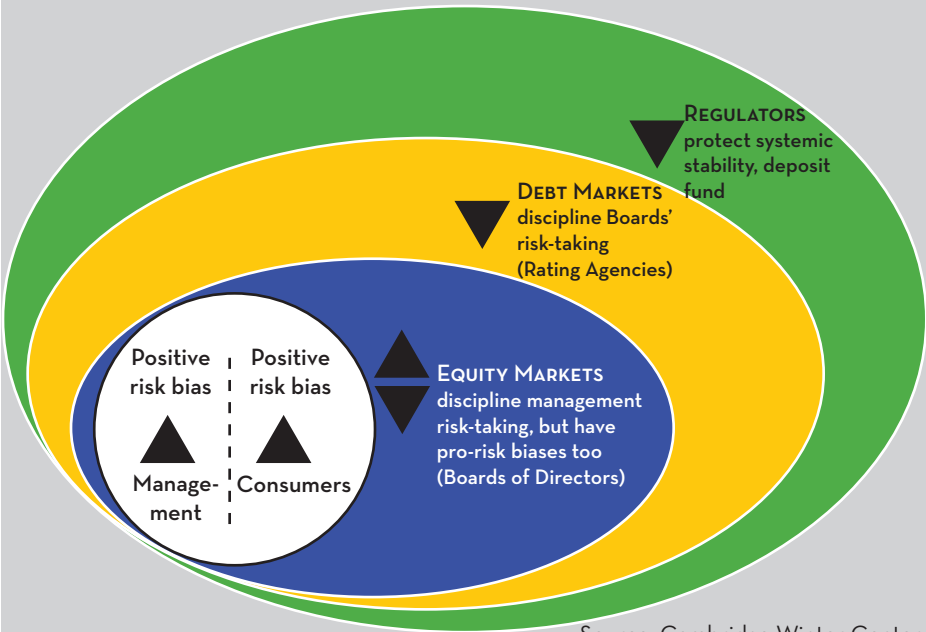
But the very nature of the government sponsored enterprises meant that this debt market check was absent. The GSEs' MBS and unsecured fixed income investors, secure in the (quite sensible, it turns out) knowledge that the taxpayer would ultimately back GSE debt, continued to fund Fannie and Freddie throughout the credit bubble and even after the bubble had begun to burst.

Of course, the wide-ranging failure of private sector mortgage markets demonstrates that the existence of non-taxpayer supported debt investors is a necessary, but by no means a sufficient, condition for sound credit allocation. The private credit markets had their own well-publicized structural shortcomings. For example, debt market discipline was diluted by the migration of capital into ABS-funded vehicles, and ABS investors, in turn, appear to have imprudently relied on the fallible judgments of credit rating agencies. At the same time, some large banks and broker dealers seem to have been viewed (correctly) as "too big to fail," so creditors sustained their asset growth despite increasingly untenable credit exposures.

Viewed in this light, the GSEs' credit allocation decisions suffered from the same general kind of structural difficulties as private-label mortgage markets during the bubble: primary market origination by banks and brokers with little economic stake in the outcome; inherently backwards-looking credit modeling techniques; and, crucially, debt market investors who were not especially interested in, or capable of, creating a substantive check on underwriting.⁷

FIGURE 4

CREDIT SYSTEMS AND RISK BIASES



Source: Cambridge Winter Center

Absent any meaningful counterbalance to the natural pro-risk and pro-cyclical credit biases faced by all financial firms, the GSEs' credit guaranty function was doomed to fail.

STABILIZE LIQUIDITY

Beyond their credit allocation function, the GSEs are intended to provide a stable source of liquidity in what can otherwise be a volatile market for residential mortgage finance. And, indeed, the GSEs provided one of the only sources of liquidity for new mortgages during the course of the credit crisis.

Unfortunately, the power of this liquidity backstop stems from two sources, neither of which seems necessary or prudent.

The first source is the implicit taxpayer backing of the GSEs' credit guaranty business. To the extent that investors believe that the United States stands behind a Fannie or Freddie credit guaranty, then an investor should be willing to invest in GSE-guaranteed MBS even in an otherwise full-blown credit crisis. But, as seen above, the credit guaranty business, precisely because of its implicit government backing, is not viable. It cannot be expected to make good risk-adjusted credit decisions without a substantive debt market check. To the extent that the GSEs' powers to backstop liquidity, then, are dependent on their credit decision-making, they rest on an irreparably shaky foundation.⁸

The second source of the GSEs' power to backstop liquidity is their portfolios. Because the GSEs are able to obtain debt financing from investors who fully expect a taxpayer bailout in a crisis, their ability to maintain, and even grow, an investment portfolio of mortgages and MBS can defy free-market gravity: their assets can climb as others sink.

This is a real benefit. But it is not additive to what the government can already accomplish, through the "official" lender of last resort, the Federal Reserve. During this financial crisis, for example, the Fed opened its funding to an unprecedented range of financial institutions, and both purchased and advanced loans against a wide range of assets – including GSE and private-label MBS.⁹ And when the Fed puts taxpayers at risk through such liquidity mechanisms, it is, ultimately, taxpayers that benefit if circumstances turn out well. With the GSEs, by contrast, considerable upside is captured by a number of private parties aside from taxpayers – GSE equity holders, GSE management, and GSE bondholders.

So it is true that the GSEs have served as important sources of liquidity to the markets. But their ability to do so has been entirely contingent on the government; and the government has better mechanisms to achieve precisely the same ends.

ABSORB RATE RISK

American homeownership rates are markedly higher than those of most other developed nations. Although a cultural predilection might contribute, elevated homeownership is also the consequence of a number of artificial economic subsidies – which extend from niche programs (e.g. the VA credit guaranty program) to large, expensive features of the tax code (e.g. the mortgage interest deduction, the exemption from income tax of certain gains from home sales). One of those subsidies is the widespread availability of long-term, fixed-rate mortgages.

For most banks, the conventional 30-year fixed rate mortgage is an awkward asset to hold on balance sheet, because of its inherent interest rate risk.¹⁰ Given this risk profile, a subsidy-free market should gravitate towards a higher share of adjustable rate mortgages (to better match asset yields with funding costs), shorter fixed rate periods on hybrid mortgages, and high pre-payment penalties (to mitigate prepayment risk). Other developed countries, like Canada, feature mortgage markets with combinations of precisely these characteristics.¹¹

The principal difference, in the US, is the existence of the GSEs. The GSEs' guaranty business does not, directly, make the interest rate risk associated with fixed rate mortgages more palatable, because the GSE guaranty compensates MBS investors for credit losses, but not prepayment or extension risk caused by changes in the rate environment. By contrast, the GSEs' portfolio business does absorb some amount of interest rate risk, and thereby might arguably increase the availability of fixed rate mortgages.

This absorption of rate risk is driven by two features of the GSEs. First, the GSEs would appear to have some level of “natural” hedge to the interest rate risk inherent in fixed rate mortgages. But that is, at best, a partial hedge to the GSEs' rate risk, and it is not different in kind to the natural hedge that would be enjoyed by any bank involved in the origination of mortgages. Thus, it is not clear that the GSEs' natural hedge encourages more fixed rate mortgage production than would exist without them.¹²

Second, given Fannie and Freddie's size and government-sponsored status, the firms might arguably be able to offload interest rate risk in the rate derivatives markets more efficiently than smaller, private firms.¹³ By doing so, though, they become systemically important counterparties within the rates markets, whose failure would create cascading crises across major market participants.

Thus, the GSEs enable fixed rate mortgages only through the introduction of systemic risk, which, in the eventuality of the GSEs' failure, was ultimately borne by the taxpayer. Given that taxpayers bear the systemic risk of the GSEs' rate risk absorption, it would be more straightforward to directly subsidize fixed rate mortgages, rather than through the intermediation of the privately owned and managed GSEs.

IMPLICATIONS

Careful analysis, then, reveals the irredeemable flaws underpinning the GSEs: their putative benefits in the provision of liquidity, and in the subsidization of fixed-rate mortgages, exist solely because they enjoy the implicit backing of taxpayers. But it is precisely that implicit taxpayer backing that destroys the integrity of their credit decision-making processes.

To correct those flaws, housing finance reform, at minimum, must abide by a handful of principles – which together mean eliminating Fannie Mae and Freddie Mac:

1. Privatize the GSEs' credit guaranty business. Taxpayer-supplied subsidies for homeownership cannot be effectively delivered through taxpayer-backed credit extension. The fact of taxpayer backing destroys debt market discipline, which is a necessary ingredient for rational credit allocation.
2. Eliminate the GSEs' portfolio business, thereby nationalizing the emergency liquidity function. There is no benefit provided by the GSEs' portfolio business that is not entirely the consequence of taxpayer backing. The portfolio business achieves that which could be provided through more direct means, but needlessly transfers economic wealth from taxpayers to GSE shareholders, GSE management, and GSE bondholders.
3. Create transparent homeownership subsidies, or none at all. It is an appropriate time to reconsider whether homeownership is a judicious choice for lower and middle-income Americans – or at least whether it is so obviously judicious that it justifies massive taxpayer subsidization. If, after that review, policy-makers decide to continue promoting artificially high levels of homeownership, more straightforward cash subsidies (through refundable low-income tax credits, for example) would be both simpler than GSE intermediation, and less prone to catastrophic error.
4. Create a transparent fixed-rate mortgage subsidy, or none at all. In a similar vein, if policy-makers wish to continue to support the availability of long-term, fixed-rate mortgages, they should consider doing so directly. For example, Congress could authorize a Fed-managed rate swap facility, which would offer subsidized fixed-to-floating interest rate swaps to banks or securitization vehicles that hold fixed-rate mortgages. This would require that rate risk be absorbed by taxpayers, but taxpayers bear that risk today as well, given the systemic risk created by the GSEs' interest rate risk positions.
5. Mandate standards for private-label transparency. Due to both their dominant market share and a certain inflexibility in their IT platforms, the GSEs over time created de facto standards for the sprawling U.S. mortgage business (e.g. loan delivery standards, servicing standards) – standards that have proven alarmingly elusive in the private-label MBS market. As the GSEs are eliminated, regulators should take care

to ensure that necessary market standards are promulgated (by either private sector associations, or if necessary by regulation) in both the primary and secondary mortgage markets.

Fannie and Freddie are needlessly complex and irretrievably flawed; they must be eliminated. The resulting mortgage market will be more structurally sound, less prone to systematic credit misallocation, and less burdensome to taxpayers.

ENDNOTES

1. For simplicity, this research note does not use the term “GSEs” to include the Federal Home Loan Banks, but only Fannie and Freddie.
2. See, e.g., 12 U.S.C. 1716 et seq.; Fannie Mae, “About Fannie Mae”, available at <http://www.fanniemae.com/kb/index?page=home&c=aboutus>, accessed February 6, 2010.
3. The “primary market” refers to the market for individual mortgage loans themselves; the “secondary market” refers to mechanisms by which loans, once extended to borrowers, are sold, pooled, guaranteed, and securitized. The federal government and a variety of government sponsored enterprises participate in both the primary (the FHA, VA, and USDA) and secondary markets (Fannie, Freddie, Ginnie Mae, and the 12 Federal Home Loan Banks). See Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress*, pages 111-126 (January 30, 2010).
4. Freddie Mac, Form 10-Q for Quarter Ending September 30, 2009, note 4; Fannie Mae, Form-10Q for Quarter Ending September 30, 2009, note 6. Note that the \$100 billion figure relates to unpaid principal balance; mark-to-market fair value is rather lower.
5. See Freddie Mac, Third Quarter 2009 Financial Results Supplement, pages 18-19 (November 9, 2009). The same general trends hold at Fannie Mae as well. See Fannie Mae, 2009 Third Quarter Credit Supplement, pages 11-12 (November 5, 2009).
6. See generally Lucian A. Bebchuk, Testimony Before the Committee on Financial Services of the U.S. House of Representatives, Hearing on Compensation Structure and Systemic Risk (June 11, 2009), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/bebchuk.pdf, accessed Jan. 14, 2010.
7. Because both private-market and GSE performance suffered from precisely the same kind of problems, traditional partisan arguments regarding the GSEs tend to ring hollow. The GSEs were neither, strictly speaking, the “cause of” nor the “victim of” private-label mortgage market dysfunction. They were simply examples (albeit, by far, the largest and most costly examples) of the broad structural shortcomings within the mortgage market.
8. In theory, the Federal Home Loan Banks, which themselves enjoy some measure of implicit government backing, should be able to provide advances to member banks to provide liquidity without taking residual credit risk. In practice, though, it appears that many of the FHLBs took rather more credit risk during the bubble than they had perhaps intended.
9. See, e.g. Federal Reserve Bank of New York, Forms of Federal Reserve Lending, available at http://www.newyorkfed.org/markets/Forms_of_Fed_Lending.pdf, accessed February 7, 2010.
10. As interest rates rise, banks’ funding costs also rise, but fixed rate mortgages, definitionally, do not generate more income. The resultant squeeze in net interest margin is compounded by borrowers’ tendency to reduce early prepayments of fixed rate mortgages in a rising rate environment, so the now-less profitable fixed rate mortgages also, unhelpfully, stay on bank balance sheets longer. This “extension risk” has an analog, “prepayment risk”, in a falling rate environment. As rates drop, borrowers quite naturally refinance fixed rate mortgages, leaving banks to reinvest prepaid mortgage balances in a now-lower ambient rate environment.
11. See John Kiff, *Canadian Residential Mortgage Markets: Boring but Effective?*, International Monetary Fund Working Paper WP/09/130 (June 2009).
12. To the extent that GSE revenue is driven, in part, by new mortgage deliveries, then that

revenue should increase as interest rates decline, because lower interest rates typically drive higher delivery volumes. At the same time, declining interest rates should trigger prepayments, and thereby reduce the value of the GSE portfolios of fixed-rate mortgages or MBS. Those opposing influences on profitability (one up, one down) constitute a natural hedge. Because the mortgage origination business typically involves non-trivial front-end fees collected from borrowers, a similar kind of natural hedge would exist for any bank that originates mortgages and holds fixed-rate assets.

13. It is theoretically possible for the GSEs to hedge substantially all of their interest rate risk positions, by using a combination of interest rate derivatives. But in general they have chosen to retain some level of unhedged interest rate risk, to capture incremental value. See generally Dwight M. Jaffee, The Interest Rate Risk of Fannie Mae and Freddie Mac, *Journal of Financial Services Research*, Vol. 24, No. 1, pages 5-29 (2004).

RAJ DATE

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The views expressed in this paper are those of the author and do not necessarily reflect the positions of the Roosevelt Institute, its officers, or its directors.

REGULATOR'S INCENTIVES

Richard Scott Carnell

The financial debacle has caused worldwide pain and helped saddle Americans with an oversized public debt. “And yet,” to echo President Franklin D. Roosevelt’s inaugural address, “our distress comes from no failure of substance. We are stricken by no plague of locusts. . . . Plenty is at our doorstep.” Our financial system got into extraordinary trouble—trouble not seen since the Great Depression—during a time of record profits and great prosperity.

This disaster had many causes, including irrational exuberance, poorly understood financial innovation, loose fiscal and monetary policy, market flaws, and the complacency that comes with a long economic boom. But in banking the debacle was above all a regulatory failure. Bank regulators had ample discretionary powers to establish and enforce high standards of safety and soundness; they faced no insuperable regulatory gaps. They could, for example, have increased the required capital levels set during the 1980s instead of leaving those levels unchanged during two decades of prosperity and record profits. They could have used risk-based capital standards to constrain excessive exposure to the largest financial institutions, limit investments in the riskiest subprime mortgage-backed securities, curb other concentrations of credit risk, and require systemically significant banks to hold additional capital. Had regulators adequately used their powers, they could have made banking a bulwark for our financial system instead of a source of weakness. In banking, as in the system as a whole, we have witnessed the greatest regulatory failure in history.

The Treasury proposal and the House-passed Wall Street Reform and Consumer Protection Act of 2009 respond to this failure with more of the same—more discretionary powers without more accountability. They would leave unchanged the incentives that draw regulators toward laxity during good times. They would do too little to correct critical structural problems in our financial system. On the contrary, their approach would entrench and expand too-big-to-fail treatment and heighten moral hazard. In the name of financial stability, it would tend to exacerbate the cycle of boom and bust and magnify financial instability. Congress should act now to counteract perverse regulatory incentives and to correct the key defects examined elsewhere in this report. Structural problems demand structural reforms.

REGULATORS' PERVERSE INCENTIVES

Bank regulators’ failures partly reflect imperfect foresight, a frailty common to us all. But they also reflect incentives that discourage regulators from taking strong, timely action to protect bank soundness, the insurance fund, and the taxpayers. These perverse incentives represent the regulatory counterpart of moral hazard. Just as moral hazard encourages financial institutions to take excessive risks, these incentives discourage regulators from taking adequate precautions. To improve regulation, we need to give regulators a better set of incentives.

Regulators' perverse incentives arise largely from the nature of banking (a point to which I will return shortly) and the dynamics of interest-group politics. The benefits of overly risky banking are concentrated in banks' owners, managers, counterparties, and borrowers. These players have incentives to defend aggressive bank's practices against regulatory constraint. Taxpayers, by contrast, are numerous and unorganized and ordinarily pay little attention to bank soundness regulation. The organized, motivated few exert more political influence than the unorganized, uninformed many.

In any event, banking is by nature relatively opaque. Many bank assets lack ready markets. Valuing those assets entails judgment and is susceptible to manipulation by management. Outsiders accordingly have difficulty assessing banks' true financial condition. We as citizens have corresponding difficulty ascertaining regulators' effectiveness in keeping banks healthy.

Banks are also fragile. Their liabilities are more liquid than their assets: they use checking deposits to make five-year commercial loans. No bank holds enough cash to repay all depositors at once, nor could any bank that did so remain profitable. Banks fund their assets mostly with debt (e.g., \$12 in liabilities per dollar of equity), which leaves banks acutely vulnerable to losses on their loans and other investments. Losing 9 cents per dollar of assets may exhaust a bank's equity. Moreover, regardless of their own financial condition, banks must pay deposits and other liabilities at par (i.e., 100 cents per dollar) or face closure. In sum, by the time a bank's regulator recognizes and decides to act against a bank's problems, the bank's prospects may already be impaired.

Mutual funds provide an instructive contrast. They invest in securities or other financial instruments traded on exchanges or in other ready markets. Market prices provide objective evidence of asset value. Funds that need cash can sell assets quickly without discounting the price. Moreover, funds raise money mostly if not entirely with equity. An investor who redeems her stock receives not the price she paid but her proportionate share of the fund's net assets. If asset prices have fallen since she bought her stock, she (not the fund) will bear the loss. This structure makes mutual funds more transparent and in important respects more resilient than banks.

Uncertainty about banks' financial condition makes regulators' jobs more challenging. It also creates leeway for regulators, consciously or unconsciously, to act in their own interests at the expense of the insurance fund and the taxpayers. If we as citizens could readily and reliably ascertain banks' condition, regulators who let banks deteriorate would soon harm their own reputations. But reality offers no such simple correctives. A bank can look healthy and report record profits even as it slides toward major losses. We may recognize the bank's problems only after the losses become obvious.

Given this uncertainty, regulators may stand to lose by taking resolute corrective and preventive action. Imagine yourself becoming a top bank regulator mid-

way through an economic boom and possible real estate bubble. Your amiable predecessor received high accolades from Congress and the industry. Banks look robustly healthy. But you have concluded that you should tighten supervision and phase in higher capital standards. You weigh the likely consequences of those steps. Banks will gradually become more resilient. We will ultimately have fewer bank failures, smaller insurance losses, and less risk to the taxpayers than we otherwise would have. Yet you may receive little credit for those achievements. When the boom ends, we will in any event have more failures than under your luckier but less vigilant predecessor. To the untutored eye, you will still look less successful. Few people will ever think of the problems you averted.

Meanwhile, your program will have immediate, readily identifiable costs. Banks will pare dividends and tighten lending standards. Their return on equity will decline as they hold more equity per dollar of assets. You will draw sharp criticism from bank trade associations, homebuilders, real estate developers, talk-show hosts, and members of Congress. They will accuse you of capriciously endangering jobs, housing markets, entrepreneurship, and the nation's prosperity. After all, conventional wisdom saw no danger, no reason for stringency. From the standpoint of strict self-interest, you would have fared better by going with the flow.

For regulators' reputations suffer less from problems that develop on their watch than from problems that become public on their watch. The careers of President Reagan's three chief thrift regulators sadly illustrate this pattern. The first, Richard T. Pratt (1981-83), pursued disastrous policies of deregulation and capital forbearance but left before their consequences became apparent. He became a partner at Goldman Sachs. The second, Edwin J. Gray (1983-87), initially followed Pratt's lax policies but later worked to rein in overly risky investments, restore capital discipline, strengthen his agency's examiner corps, and recapitalize thrifts' deposit insurance fund. His position became untenable when he lost the industry's political support, and he left to head a troubled thrift in Miami. The third, M. Danny Wall (1987-89), largely continued progress toward restoring regulatory discipline. But during his tenure the insurance fund's insolvency became too grave to deny. Although Wall had not caused the insolvency, he gained notoriety for understating it and left with his reputation in tatters. He suffered less for his own errors than because the bill for others' errors came due on his watch.

In sum, we have difficulty telling good banks from bad—until it's too late. We have difficulty telling good regulation from bad—until it's too late. Lax regulation wins more friends and plaudits than stringent regulation—until it's too late. Risky banks and their allies exert more political influence than taxpayers—until it's too late. These dynamics contribute to a stubborn reality underlying the regulatory failures of the past four decades: bank soundness regulation has no political constituency—until it's too late.

REGULATORY FRAGMENTATION EXACERBATES PERVERSE INCENTIVES

Our fragmented bank regulatory structure heightens regulators' perverse incentives. Four different federal agencies regulate FDIC-insured banks and their affiliates. The Comptroller of the Currency regulates national banks. The Federal Reserve regulates state banks that have joined the Federal Reserve System and most companies that own commercial banks. The FDIC regulates state banks not in the Federal Reserve System. The Office of Thrift Supervision regulates thrifts and their parent companies. The four agencies compete to attract and retain regulatory clientele. A bank can switch from one regulator to another by changing its charter or Fed membership.

Senator William Proxmire called this structure "the most bizarre and tangled financial regulatory system in the world." Federal Reserve Vice Chairman J.L. Robertson branded it "a happenstance and not a system." No other country has competing bank regulators. No other U.S. industry has competing federal regulators.

The crazy-quilt of overlapping jurisdiction and duplicative functions exacerbates bank regulators' perverse incentives:

- It encourages unsound laxity by setting up interagency competition and leaving regulators overly deferential to their bank clientele.
- It undercuts accountability by confusing members of Congress, reporters, and citizens (and sometimes regulators themselves) about which agency is responsible for what.
- It slows decision-making and can hinder action to prevent future problems. Interest groups can play off regulators against each other. A single stodgy, stubborn, or overly solicitous agency head can obstruct action, declaring, "if it ain't broke, don't fix it." Not surprisingly, the agencies work better when responding to present problems than when trying to head off problems.
- It divides authority over integrated banking organizations—corporate families in which banks deal extensively with their affiliates—among two or more agencies, each charged with supervising only part of the organization. In so doing, it blunts each agency's accountability and impedes the process of identifying and correcting problems.
- It leaves individual agencies smaller, weaker, and more vulnerable to special-interest pressure than a unified agency would be. It can also impair regulators' objectivity, as occurred with thrift regulators during the 1980s.

Regulatory fragmentation played a key role in the thrift debacle. Specialized thrift regulators acted as cheerleaders for the industry. When much of the industry became insolvent, those regulators balked at taking strong, timely action. Such action would have caused the thrift industry to shrink, forced fee-dependent thrift regulators to lay off employees, and ultimately raised doubts about the need for a separate thrift regulatory system. Regulators instead let insolvent thrifts remain open, grow aggressively, exercise risky new powers, and

ultimately impose even greater losses on the insurance fund and the taxpayers. But the record improves when we turn from thrift-only regulators to bank regulators who also supervised thrifts. Those bank regulators restricted troubled thrifts' growth and closed deeply insolvent institutions. At the state level, thrifts regulated by state banking commissioners failed less often and caused smaller insurance losses than thrifts with specialized, thrift-only regulators. At the federal level, thrifts regulated by the FDIC fared far better than those regulated by the thrift-only Federal Home Loan Bank Board.

BANKING STATUTES IMPOSE INADEQUATE ACCOUNTABILITY

Properly framed statutory standards can heighten regulators' accountability and counteract perverse incentives. Congress did employ such standards when requiring regulators to take "prompt corrective action" to resolve capital deficiencies at FDIC-insured banks. Such banks face progressively more stringent restrictions and requirements designed to correct problems before they grow large and in any event before they cause losses to the insurance fund. A regulator can accept an undercapitalized bank's capital restoration plan, and thus permit the bank to grow, only by concluding that the plan "is based on realistic assumptions, and is likely to succeed in restoring the institution's capital." If the bank's capital falls so low that the bank has more than \$98 in liabilities for each \$100 of assets, the FDIC must take control of the bank unless the regulator and the FDIC agree on an alternative approach that would better protect the FDIC. 12 U.S.C. § 1831o. These standards have teeth. They limit regulatory procrastination and provide clearer, more consequences for capital deficiencies.

Yet Congress often gives bank regulators broad discretionary powers without adequate rules, standards, and accountability. The Federal Reserve Board can permit a financial holding company to engage in any activity that the board believes is "complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally." 12 U.S.C. § 1843(k)(1)(B). This standard imposes no meaningful constraint. What lawful activity would inherently pose "a substantial risk to . . . the financial system generally." Such a risk might arise from operating nerve-gas pipelines, creating lethal computer viruses, or training aspiring hackers to cripple competing financial institutions' computers. Yet those activities would be illegal. The statute lets the Fed authorize whatever activities it pleases—an approach that makes sense only if Congress has little concern about the breadth of activities in which bank-affiliated firms can engage. Exceedingly permissive standards also apply when the Fed classifies activities as "financial" and thus permissible for financial holding companies.

RECOMMENDATIONS

- Congress should unify federal bank soundness regulation in a new independent agency. The agency would supervise all FDIC-insured banks and thrifts and their parent companies. Its governing board should include representatives of the Treasury, Federal Reserve, and FDIC. This unified structure would maximize accountability, curtail bureaucratic

infighting, and facilitate timely action. It would also help the agency maintain its independence from special-interest pressure. The agency would be larger and more prominent than its predecessors (in their role as bank regulators) and would supervise a broader range of banking organizations. It would thus be less beholden to a particular industry clientele (e.g., thrifts) and better able to persevere in appropriate preventive and corrective action. Moreover, a unified agency could more effectively supervise integrated banking organizations, including those whose unsound risk-taking helped fuel the recent financial crisis.

- Congress should prescribe clear, focused, realistic goals for the new supervisory agency, the FDIC as deposit insurer, and the Federal Reserve as lender of last resort.
- Congress should frame important statutes in ways that reinforce regulators' accountability and help them withstand pressure for unsound laxity. In so doing, it should consider the pressures and temptations regulators will face in administering the statute and the type of errors regulators would be most likely to make.
- Regulators should strengthen capital requirements. Bank soundness regulation has too often failed us, and the financial system has become riskier over the past several decades. Thus it makes sense to require banks to hold additional capital as a buffer against unexpected losses.
- Regulators should raise the capital triggers for prompt corrective action—triggers set low during the last banking crisis and not increased since. Higher capital triggers would reinforce incentives for banks to hold ample capital, better achieve the statutory purpose of avoiding or minimizing loss to the insurance fund, and help constrain regulatory procrastination.
- Both Congress and regulators should bear in mind the limits of regulation, particularly when faced with strong moral hazard. Regulators should work to restore market discipline on large financial institutions. Members of Congress, in overseeing regulators' performance, should insist on timely progress toward that goal.

RICHARD CARNELL

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The views expressed in this paper are those of the author and do not necessarily reflect the positions of the Roosevelt Institute, its officers, or its directors.

CREDIT RATING AGENCIES & REGULATION

WHY LESS IS MORE

Lawrence J. White

The three large U.S.-based credit rating agencies – Moody’s, Standard & Poor’s, and Fitch – provided excessively optimistic ratings of subprime residential mortgage-backed securities (RMBS) in the middle years of this decade actions that played a central role in the financial debacle of the past two years. The strong political sentiment for heightened regulation of the rating agencies – as expressed in legislative proposals by the Obama Administration in July 2009, specific provisions in the financial regulatory reform legislation (H.R. 4173) that was passed by the House of Representatives in December, and recent regulations that have been promulgated by the Securities and Exchange Commission (SEC) – is understandable, given this context and history. The hope, of course, is to forestall future such debacles.

The advocates of such regulation want to grab the rating agencies by the lapels, shake them, and shout “Do a better job!” But while the urge for expanded regulation is well intentioned, its results are potentially quite harmful. Expanded regulation of the rating agencies is likely to:

- Raise barriers to entry into the bond information business;
- Rigidify a regulation-specified set of structures and procedures for bond rating;
- Discourage innovation in new ways of gathering and assessing bond information, new technologies, new methodologies, and new models (including new business models).

As a result, ironically, the incumbent credit rating agencies will be even more central to the bond markets, but are unlikely to produce better ratings.

There is a better policy route, which starts with an understanding of the basic purpose of the rating agencies: to provide information (in the form of judgments, or “ratings”) about the creditworthiness of bonds and their issuers. If the information is accurate, it helps bond investors – primarily financial institutions, such as banks, insurance companies, pension funds, mutual funds, etc. – make better investment decisions. It also helps the more creditworthy bond issuers stand out from the less creditworthy. If the information is inaccurate, of course, it does the opposite. As an example of the latter, the major agencies had “investment grade” ratings on Lehman Brothers’ debt on the morning that it filed for bankruptcy. Luckily the large incumbent rating agencies are not – and never have been – the sole sources of creditworthiness information. Many large institutions do their own research; there are also smaller advisory firms; and most large securities firms employ “fixed income analysts” who provide information and recommendations to their firms’ clients.

The next step along this better policy route is the recognition that the centrality of only the three major rating agencies for the bond information process is a major part of the problem. This central role of the agencies has been mandated by more than 70 years of “safety-and-soundness” financial regulation of banks and other financial institutions, including insurance companies, pension funds, money market mutual funds, and securities firms. In essence, the regulators rely on the ratings to determine the safety of institutional bond portfolios. For example, bank regulators currently forbid (and have done so since 1936) banks from holding “speculative” (i.e., “junk”) bonds, as determined by the rating agencies’ ratings. This kind of regulatory reliance on ratings has imbued these third-party judgments about the creditworthiness of bonds with the force of law!

This problem was compounded when the SEC created the category of “nationally recognized statistical rating organization” (NRSRO) in 1975 and in doing so created a major barrier to entry into the rating business. As of year-end 2000 there were only three NRSROs to whom bond issuers could obtain their all-important ratings: Moody’s, Standard & Poor’s, and Fitch. (Because of subsequent prodding by the Congress, and then the specific barrier-reduction provisions of the Credit Rating Agency Reform Act of 2006, there are now ten NRSROs. But, because of the inertia of incumbency, the three large rating agencies continue to dominate the business.)

When this (literal) handful of rating firms stumbled badly in their excessively optimistic ratings of the subprime RMBS, the consequences were disastrous because of their regulation-induced centrality.

A better policy prescription would increase competition in the provision of bond information by eliminating regulatory reliance on ratings altogether. Since the bond markets are primarily institutional markets (and not retail securities markets, where retail customers are likely to need more help from regulators), market forces with respect to the provision of information about bonds can be expected to function well, rendering the detailed regulation that has been proposed (and partly embodied already in SEC regulations) unnecessary. Indeed, if regulatory reliance on ratings were eliminated, the entire NRSRO superstructure could be dismantled, and the NRSRO category could be eliminated, which would bring many new sources of information into the market and in so doing also increase the quality of information.

The regulatory requirements that prudentially regulated financial institutions must maintain appropriately safe bond portfolios should remain in force. But the burden should be placed directly on the regulated institutions to demonstrate and justify to their regulators that their bond portfolios are safe and appropriate – either by doing the research themselves, or by relying on third-party advisors. Since financial institutions could then call upon a wider array of sources of advice on the safety of their bond portfolios, the bond information market would be opened to innovation and entry in ways that have not been possible since the 1930s.

THE “ISSUER PAYS” BUSINESS MODEL OF THE MAJOR CREDIT RATING AGENCIES

The politically popular proposals for expanding the regulation of the credit rating agencies (as well as the SEC’s recent regulations) are devoted primarily to efforts to increase the transparency of ratings and to address issues of conflicts of interest. The latter arise largely from the major rating agencies’ business model of relying on payments from the bond issuers (an “issuer pays” business model) in return for rating their bonds.

Again, the underlying urge to “do something” in the wake of the mistakes of the major credit rating agencies during the middle years of the decade of the 2000s is understandable. Further, the “issuer pays” business model of those rating agencies presents obvious potential conflict-of-interest problems that appear to be crying out for correction. But the major credit rating agencies switched to the “issuer pays” model in the early 1970s (they previously sold their ratings directly to investors – an “investor pays” business model); yet the serious problems only arose three decades later. The agencies’ concerns for their long-run reputations and the transparency and multiplicity of issuers prior to the current decade all served to keep the potential conflict-of-interest problems in check during those three intervening decades.

In the decade of the 2000s, however, this reputation-based integrity eroded. The profit margins on RMBS instruments were substantially larger than those on ordinary debt issuances, and the issuers of RMBS were far fewer than the thousands of issuers of “plain vanilla” corporate and municipal bonds. This made the threat by a RMBS issuer to take its business elsewhere unless a rating agency provided favorable ratings far more potent. Also, the RMBS instruments were far more complex and opaque than “plain vanilla” corporate and municipal debt, so mistakes and errors (unintentional, or otherwise) were less likely to be noticed quickly by others. And the major credit rating agencies, like so many other participants in the RMBS process, came to believe that housing prices would always increase, so that even subprime mortgages – and the debt securities that were structured from those mortgages – would never be a problem. The result? A tight, protected oligopoly became careless and complacent.

In many ways, it was “The Perfect Storm.”

Even so, this storm would not have had such devastating consequences if financial regulators had not propelled the three major agencies into the center of the bond markets, where regulated financial institutions were forced to heed the judgments of just those three.

THE DANGERS OF EXPANDED REGULATION OF THE RATING AGENCIES

The dangers of expanded regulation of the rating agencies are substantial. They require the SEC to delve ever deeper into the processes and procedures and methodologies of credit judgments. In so doing, such expanded regulation is

likely to rigidify the industry along the lines of whatever specific implementing regulations the SEC devises. It is also likely to increase the costs of being a credit rating agency. Expanded regulation will discourage entry and impede innovation in new ways of gathering and assessing information, in new methodologies, in new technologies, and in new models – including new business models. Even requirements for greater transparency, such as more information about the rating agencies' methodologies, rating histories, and track records, could have adverse consequences if they force the revelation of proprietary information about the modeling and thereby discourage firms from developing new models.

Further, expanded regulation may well fail to achieve the goal of improving ratings. One common complaint about the large agencies is that they are slow to adjust their ratings in response to new information. This criticism surfaced strongly in the wake of the Enron bankruptcy in November 2001, with the revelation that the major rating agencies had maintained “investment grade” ratings on Enron's debt until five days before that company's bankruptcy filing. More recently, as mentioned above, the major agencies had “investment grade” ratings on Lehman Brothers' debt on the morning that it filed for bankruptcy. But this sluggishness appears to be a business culture phenomenon for the incumbent rating agencies that long precedes the emergence of the “issuer pays” business model.

As for the disastrous over-optimism about the RMBS in this decade, the rating agencies were far from alone in “drinking the Kool-Aid” that housing prices could only increase and that even subprime mortgages consequently would not have problems. The kinds of regulations that have been proposed (as well as those already implemented) would not necessarily curb such herd behavior. The incumbent rating agencies are quite aware of the damage to their reputations that has occurred and have announced measures – including increased transparency and enhanced efforts to address potential conflicts – to repair that damage.

The harm to innovation from restrictive regulation is illustrated by the experience in another field: telecommunications regulation and the development of cellphone technology in the U.S. Although cellphones could have been introduced in the late 1960s, restrictive regulation held them back until the early 1980s. Cellphone usage didn't really flourish until the mid 1990s, when a less restrictive regulatory regime took hold.

THE WAY FORWARD

The rating agencies' promises to reform their ways are easy to make and could fall by the wayside after political attention shifts to other issues. Consequently, enforcement mechanisms are necessary. The rating agencies' concerns about their long-run reputations provide one potential mechanism. But that mechanism proved too weak in the near past, so something stronger is needed. Expanded regulation of the rating agencies (to address the transparency and con-

flict of interest issues) is certainly another potential route – but the dangers, as outlined above, are substantial.

Expanded competition among current and potential providers of information about the creditworthiness of bonds and bond issuers is a third – and preferable – route. New competition could come from the smaller bond advisory firms or from advisory firms in other parts of the securities business (e.g., in December 2009 Morningstar, Inc., which is known primarily for its assessments of mutual funds, announced that it would begin rating some companies' bonds). Competition could also come from some of the fixed income analysts at large securities firms who might (in a less regulated environment) decide to establish their own advisory companies, or from new entrants that no one has ever heard of before. Since the bond markets are primarily institutional markets, the bond managers of the financial institutions in these markets can be expected to have the ability to choose reliable advisors. Expanded competition would be enabled by the elimination of regulatory reliance on ratings, and enhanced by a reduction in (or, ideally, an absence of) regulation of the bond information advisory/rating process.

This withdrawal of regulatory reliance on ratings must be accompanied by an enhanced approach by prudential regulators of banks and other financial institutions in how they enforce requirements that their regulated financial institutions maintain appropriately safe bond portfolios. In essence, the regulators must place the burden for safe bonds directly on the financial institutions, thereby replacing the regulators' current delegation (or, equivalently, outsourcing) of the safety decision to a handful of third-party rating agencies. The financial institutions could do the research themselves, or enlist the help of an advisory firm, which could be one of the incumbent rating agencies or a new competitor. The prudential regulators would have to maintain surveillance of the advisory process; but the primary focus would be on the safety of the bonds themselves.

The SEC has taken some recent steps in the direction of this third route by eliminating some regulatory references to ratings; but no other financial regulatory agency has followed the SEC's lead.¹ The SEC has simultaneously expanded its regulation of the rating agencies. The financial regulatory reform legislation (H.R. 4173) that was passed by the House of Representatives in December would eliminate legislative references to ratings and instruct financial regulators to eliminate reliance on ratings in their regulations; but it would also greatly expand the regulation of the rating agencies.

In essence, public policy currently appears to be two-minded about the credit rating agencies: The wisdom of eliminating regulatory reliance on ratings has gained some recognition; but the political pressures to heighten the regulation of the rating agencies are clearly formidable.

CONCLUSION

There is a better policy route than relying on the incumbent credit rating agencies to police themselves, or on the politically popular route of expanded regulation of the rating agencies. This better alternative would entail:

- The elimination of all regulatory reliance on ratings, by the SEC and by all other financial regulators; in essence, elimination of the force of law that has been accorded to these third-party judgments. Instead of relying on a small number of rating agencies for safety judgments about bonds, financial regulators should place the burden directly on their regulated financial institutions to justify the safety of their bond portfolios.
- The elimination of the special regulatory category for rating agencies, which was created by the SEC 35 years ago.
- The reduction (or, preferably, the elimination) of the expanded regulation that has recently been applied to those rating agencies.
- These actions would encourage entry and innovation in the provision of creditworthiness information about bonds.

The institutional participants in the bond markets - with appropriate oversight by financial regulators - could then more readily make use of a wider set of providers of information. As a consequence, the bond information market would be opened to new ideas and new entry in a way that has not been possible for over 70 years.

ENDNOTES

1. However, in late 2009 there were two small steps in a favorable direction: In October the Federal Reserve announced that it would be more selective with respect to which ratings it would accept in connection with the collateral provided by borrowers under the Fed's "Term Asset-Backed Securities Lending Facility" (TALF) and would also conduct its own risk assessments of proposed collateral; and in November the National Association of Insurance Commissioners (NAIC) announced that it had asked the Pacific Investment Management Company (PIMCO) - which is not a NRSRO - to provide a separate risk assessment of residential mortgage-backed securities that were held by insurance companies that are regulated by the 50 state insurance regulators.

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THE BROKEN CONSUMER CREDIT MARKET

Elizabeth Warren

A century ago, anyone with a bathtub and some chemicals could mix and sell drugs – and claim fantastic cures. These “innovators” raked in profits by skillfully marketing lousy products because customers were poorly equipped to tell the difference between effective and ineffective treatments. In the decades following, the Food and Drug Administration developed some basic rules about safety and disclosure, and everything changed. Companies had greater incentives to invest in research and to develop safer, more effective drugs. Eliminating bad remedies made room for creating good ones.

Nearly every product sold in America today has passed basic safety regulations well in advance of being put on store shelves. A focused and adaptable regulatory structure for drugs, food, cars, appliances and other physical products has created a vibrant market in which cutting edge innovations are aimed toward attracting new consumers. By contrast, credit products are regulated by a bloated, ineffective concoction of federal and state laws that have failed to adapt to changing markets. Costs have risen, and innovation has produced incomprehensible terms and sharp practices that have left families at the mercy of those who write the contracts.

While manufacturers have developed iPods and flat-screen televisions, the financial industry has perfected the art of offering mortgages, credit cards, and check-overdrafts laden with hidden terms that obscure price and risk. Good products are mixed with dangerous products, and consumers are left on their own to try to sort out which is which. The consequences can be disastrous. More than half of the families that ended up with high-priced, high-risk subprime mortgages would have qualified for safer, cheaper prime loans.¹ A recent Federal Trade Commission (FTC) survey found that many consumers do not understand, or can even identify, key mortgage terms.² After extensive study, the Federal Reserve found that homeowners with adjustable rate mortgages (ARMs) were poorly informed about the terms of their mortgages.³ Research from the Department of Housing and Urban Development (HUD) concluded that, “[t]oday, buying a home is too complicated, confusing and costly. Each year, Americans spend approximately \$55 billion on closing costs they don’t fully understand.”⁴

This information gap between lender and borrower exists throughout the consumer credit market. The so-called “innovations” in credit charges—including teaser rates, negative amortization, increased use of fees, universal default clauses, and penalty interest rates—have turned ordinary credit transactions into devilishly complex undertakings. Study after study shows that credit products are deliberately designed to obscure the real costs and to trick consumers.⁵ The average credit-card contract is dizzying—and 30 pages long, up from a

page and a half in the early 1980s.⁶ Lenders advertise a single interest rate on the front of their direct-mail envelopes while burying costly details deep in the contract.

Creditors try to explain away their long contracts with the claim that they need to protect themselves from litigation. This ignores the fact that creditors have found many other effective ways to insulate themselves from liability. Arbitration clauses, for example, may look benign to the customer, but their point is often to permit the lender to escape the reach of class-action lawsuits. The result is that the lenders can break and, if the amounts at stake are small, few customers would ever sue. Legal protection is only a small part of the proliferating verbiage.

Faced with impenetrable legalese and deliberate obfuscation, consumers can't compare offers or make clear-eyed choices about borrowing. Creditors can hire an army of lawyers and MBAs to design their programs, but families' time and expertise have not expanded to meet the demands of a changing credit marketplace. As a result, consumers sign on to credit products focused on only one or two features—nominal interest rates or free gifts—in the hope that the fine print will not bite them. Real competition, the head-to-head comparison of total costs that results in the best products rising to the top, has disappeared.

REGULATORY FAILURE

The lack of meaningful rules over the consumer credit market is the direct result of a sluggish, bureaucratic regulatory system. Today, consumer protection authority is scattered among seven federal agencies. Each of those agencies has plenty of workers on payroll and plenty of budgeting. But not one of those agencies has real accountability for making consumer protection work, and, as a result, not one has been successful at doing so.

The seven agencies with a piece of consumer protection have failed to create effective rules for two structural reasons. The first is that financial institutions can currently shop around for the regulator that provides the most lax oversight. By changing from a bank charter to a thrift charter, for example, a financial institution can change from one regulator to another. In fact, an institution may decide to evade a federal regulator altogether by housing its operations in the states and forgoing a federal charter. Bank holding companies can shift their business from their regulated subsidiaries to those with no regulation—and no single regulator can stop them. The problem is exacerbated by the funding structure: regulators' budgets come in large part from the institutions they regulate. To maintain their size, these regulators compete to attract financial institutions, with each offering more bank-friendly regulations than the next. The result has been a race to the bottom in consumer protection.

The second structural flaw is cultural: consumer protection staff at existing agencies is small, last to be funded, and always second fiddle to the primary

mission of the agencies. At the Federal Reserve, senior officers and staff focus on monetary policy, not protecting consumers. At the Office of the Comptroller of the Currency and the Office of Thrift Supervision, agency heads worry about bank profitability and capital adequacy requirements. As the current crisis demonstrates, even when they have the legal tools to protect families, existing agencies have shown little interest in meaningful consumer protection—and there has been no accountability demanding that they do so.

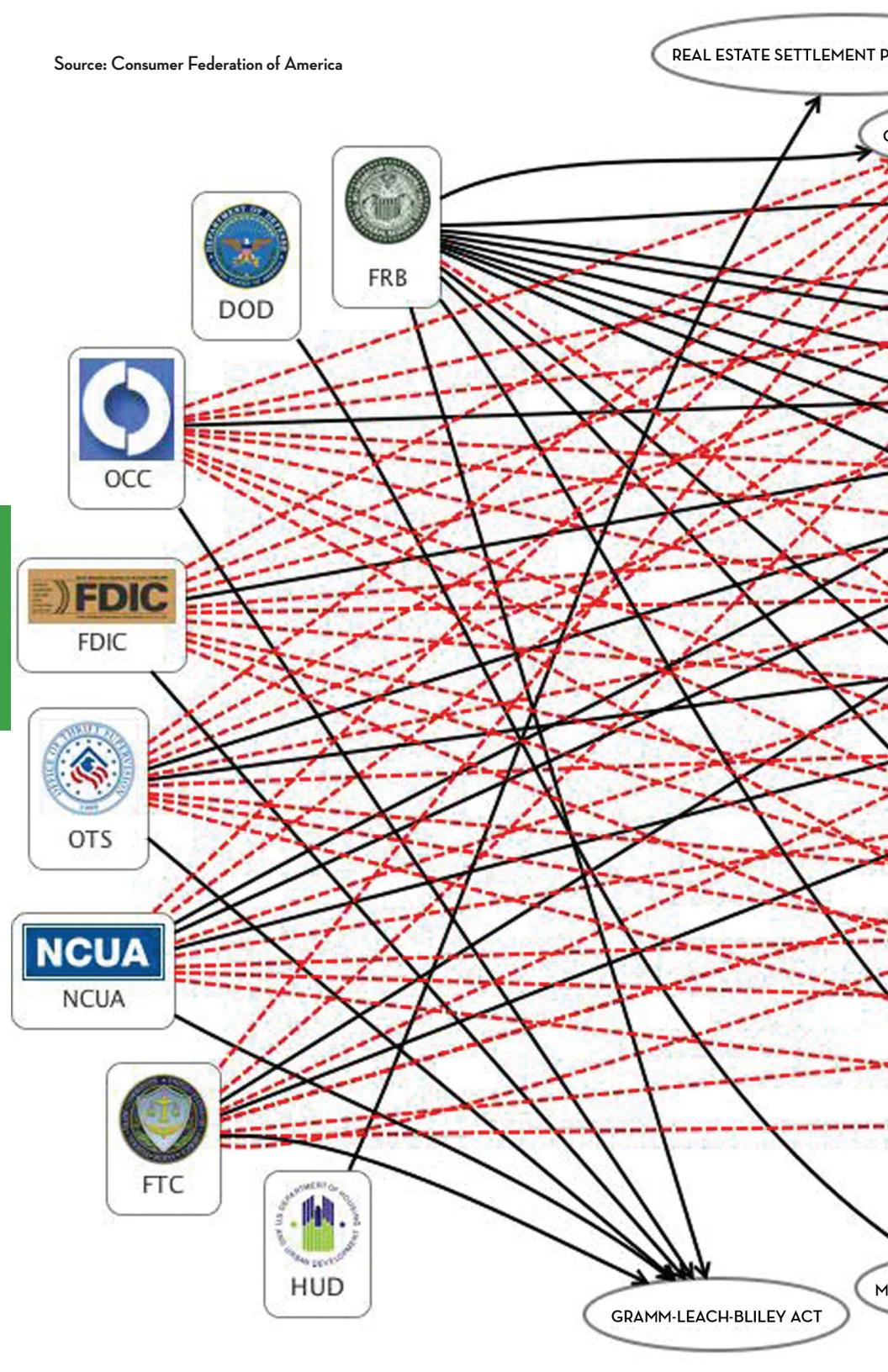
THE CONSUMER FINANCIAL PROTECTION AGENCY

The Consumer Financial Protection Agency (CFPA) is designed to fix these structural problems by consolidating the scattered authorities, reducing bureaucracy, and making sure there is an agency in Washington on the side of families. In the process, the CFPA would develop the expertise to fix the broken consumer credit market, giving families a fighting chance against the lawyers and resources of the Wall Street banks. This agency would have a clear mission, answering directly to Congress and the American people.

The CFPA has the opportunity to revolutionize consumer credit by promoting simple, straight-forward contracts that allow consumers to make better-informed choices. For decades, policymakers mistakenly followed the principle that more disclosure will promote product competition. What they missed is that more disclosure is not necessarily better disclosure. The extra fine print has given creditors pages of opportunity to trick unsuspecting customers. Comparison shopping has become impossible. The CFPA would cut through the fragmented, cumbersome, and complex consumer protection laws, replacing them with a coherent set of smarter rules that will bring more competition into the market. These rules will drive toward shorter, easier to understand agreements, like the one-page mortgage agreement promoted by the American Enterprise Institute.⁷ Shorter, clearer contracts will empower consumers to begin making real comparisons among products and to protect themselves. Better transparency will mean a better functioning market, more competition, more efficiencies, and, ultimately, lower prices for the families that use them.

In addition, the agency can reduce regulatory costs and promote a working marketplace by pre-approving templates for simple contracts designed to be read in less than three minutes—a regulatory safe harbor that would eliminate the need for companies to pay legions of lawyers to ensure compliance with the maze of laws. The lenders would still set rates, credit limits, penalties, and due dates. But consumers would be able to lay out a half-dozen contracts on the table, knowing the costs and risks right up front. They can then choose the product that best fits their needs. Banks and other lenders could continue to offer more complicated or risky products—as long as the risks are disclosed so that customers can understand them without relying on a team of lawyers.

See illustration 



PROTECTION ACT

CONSUMER LEASE ACT

CONSUMER PROTECTION

TODAY

TRUTH IN LENDING ACT

TRUTH IN SAVINGS

FAIR CREDIT REPORTING ACT

ELECTRONIC FUND TRANSFER ACT

FTC ACT

CHECK 21

EQUAL CREDIT OPPORTUNITY ACT

FAIR DEBT COLLECTION PRACTICES ACT

HOME OWNERS PROTECTION ACT

HOME OWNERSHIP AND EQUITY PROTECTION ACT

CREDIT CARD ACCOUNTABILITY, RESPONSIBILITY AND DISCLOSURE ACT

HOME MORTGAGE DISCLOSURE ACT

MILITARY LENDING ACT

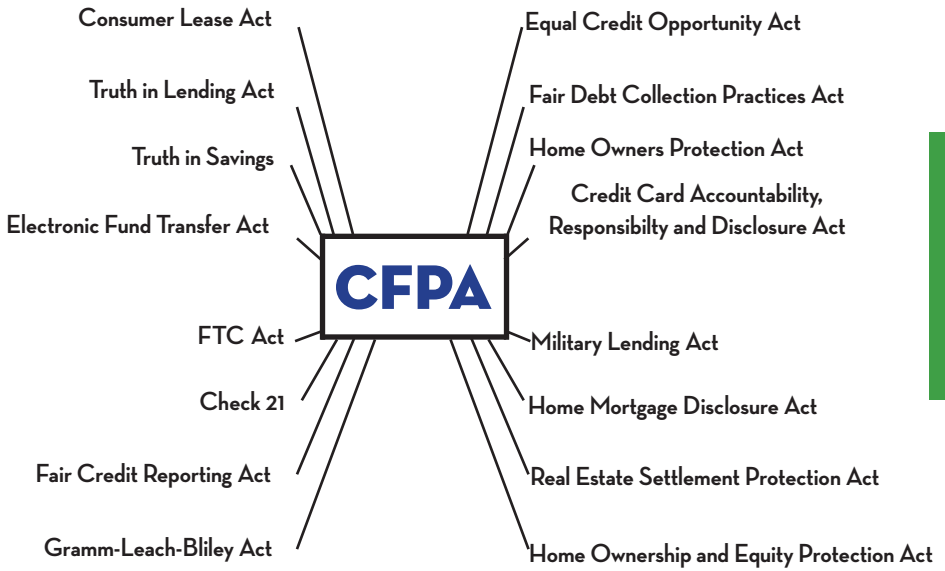
LEGEND

BLACK SOLID LINES INDICATE RULE WRITING/ENFORCEMENT

RED DASHED LINES INDICATE ONLY ENFORCEMENT

CONSUMER PROTECTION

or 



Source: Consumer Federation of America

CONCLUSION

Nothing will ever replace the role of personal responsibility. The FDA cannot prevent drug overdoses, and the CFPA cannot stop overspending. Instead, creating safer marketplaces is about making certain that the products themselves don't become the source of trouble. With consumer credit, this means that terms hidden in the fine print or obscured with incomprehensible language, reservation of all power to the seller with nothing left for the buyer, and similar tricks have no place in a well-functioning market. A credit-card holder who goes on an unaffordable shopping spree should bear the consequences, as should someone who buys an oversize house or a budget-busting new car. But most consumers—those willing to act responsibly—would thrive in a credit marketplace that makes costs clear up front. And for the vast majority of financial institutions that would rather win business by offering better service or prices than by hiding “revenue enhancers” in fine print, the CFPA would point the way to an efficient and more competitive financial system.

ENDNOTES

1. Rick Brooks and Ruth Simon, Subprime Debacle Traps Even Very Credit-Worthy, *Wall Street Journal* (Dec. 3, 2007); Financial Services in Distressed Communities, Fannie Mae Foundation (Aug. 2001).
2. See James M. Lacko and Janis K. Pappalardo, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms*, Federal Trade Commission Bureau of Economics Staff Report (June 2007) (online at www.ftc.gov/os/2007/06/PO25505MortgageDisclosureReport.pdf). For example, 95% of respondents could not correctly identify the prepayment penalty amount, 87% could not correctly identify the total up-front charges amount, and 20% could not identify the correct APR amount.
3. See Brian Bucks and Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?*, Federal Reserve Board, at 26-27 (Jan. 2006) (online at www.federalreserve.gov/pubs/feds/2006/200603/200603pap.pdf).
4. U.S. Department of Housing and Urban Development, News Release (June 27, 2005) (online at www.hud.gov/news/release.cfm?content=pr05-091.cfm).
5. For a more detailed discussion of the difficulties customers face in trying to decipher their credit agreements, see Oren Bar-Gill and Elizabeth Warren, Making Credit Safer, *University of Pennsylvania Law Review* (2008) (online at www.pennumbra.com/issues/article.php?aid=198). The research from that paper is summarized here.
6. Brian Grow and Robert Berner, About that New, “Friendly” Consumer Product, *BusinessWeek* (Apr. 30, 2009); Mitchell Pacelle, Putting Pinch on Credit Card Users, *Wall Street Journal* (July 12, 2004). For example, Citibank's credit card agreement was about 600 words—one page of normal type.
7. Alex J. Pollock, The Basic Facts About Your Mortgage Loan (online at http://www.aei.org/docLib/20070913_20070515_PollockPrototype.pdf).

ELIZABETH WARREN

Professor Elizabeth Warren is the Leo Gottlieb Professor of Law at Harvard University and the Chair of the TARP Congressional Oversight Panel. She has written eight books and more than a hundred scholarly articles dealing with credit and economic stress, and she first developed the idea for a Consumer Financial Protection Agency and has been one of its leading activists. *Time* named her one of the 100 Most Influential People in the World in May 2009, and the *Boston Globe* named her “Bostonian of the Year” in December 2009.

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OUT OF THE SHADOWS

CREATING A 21ST CENTURY GLASS-STEAGALL

Raj Date and Michael Konczal

The current financial crisis comes less than a decade after the culmination of a long, bipartisan effort to loosen U.S. financial services regulation. Those reforms included 1999's Gramm-Leach-Bliley Act ("GLBA"), which relaxed the post-Depression Glass-Steagall boundaries between commercial banking and investment banking.¹

This research note summarizes the logical premises that supported loosening the Glass-Steagall framework; evaluates the accuracy of those premises, given the observed market realities of the credit bubble and crisis; and recommends a path forward.

The link between the financial crisis and the relaxation of Glass-Steagall's constraints is rather more complicated than typically understood. GLBA largely relied on an internally consistent set of logical premises: (1) that widening the scope of banks' activities would allow them to reverse a long-term secular decline in competitiveness; (2) that non-depository "shadow banks" should continue to compete in the banking business, because free market discipline would force them to make sound credit risk-return decisions; and (3) that even if shadow banks failed to make good credit decisions, their resulting bankruptcies would not result in taxpayer harm.

To most policymakers at the time, those premises seemed sound. But in hindsight, all three premises have proven disastrously false in the marketplace.

Except for the few largest bank holding companies, the opportunity to enter the securities business has not made banks any more competitive. Moreover, it turns out that non-banks (e.g. Merrill Lynch, GE Capital, CIT, GMAC, the GSEs) made breathtakingly bad credit risk-return decisions. And the lack of any bank-like regulatory governors on growth allowed leading shadow banks to grow so explosively during the credit bubble that, when they failed, taxpayers were forced by two successive Administrations to support them, for fear of the collateral damage of such large firms' collapse.

Congress did not create the crisis through the 1999 deregulation. But by focusing on the deregulation of banks, instead of managing the already growing systemic risk of the shadow banks, Congress not only enabled the financial crisis, it may well have hastened it.

In light of that experience, policymakers should now focus on a new kind of Glass-Steagall — one that prevents shadow banks from creating the same kinds of risks again.

THE LOGIC OF GLBA

The proponents of GLBA did not intend to increase risk within the financial system. On the contrary, GLBA represented an attempt to mitigate a secular decline in the importance and profitability of the banking system, and an apparent increase in its risk.

Structural Shift

In the 25 years before GLBA, commercial banks' share of U.S. financial assets had declined by more than half. Banks' key structural role in the intermediation of credit and interest risk was slowly being supplanted. (See Figure 1).

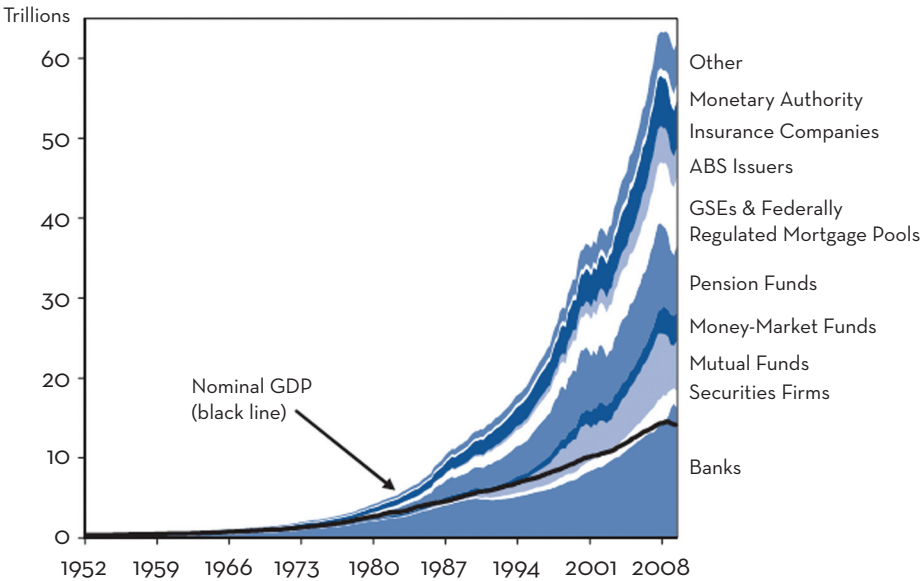
RISE OF SHADOW BANKS

The deposit-funded commercial banking system was being steadily replaced by the capital market-funded "shadow banking" system.² Shadow banks, in the most useful definition, are firms that hold assets similar to commercial banks', but with liabilities more like investment banks'. (See Figure 2).

Commercial banks' traditional assets typically comprise relatively illiquid commercial and consumer loans. Banks' traditional funding relies heavily on core deposits. Because deposit funding enjoys some measure of FDIC insurance and is provided by independent, atomized depositors, it tends to be relatively "sticky" in the face of exogenous shocks. It tends not to dissipate quickly as market conditions worsen.³ Such a resilient source of funding fits

FIGURE 1

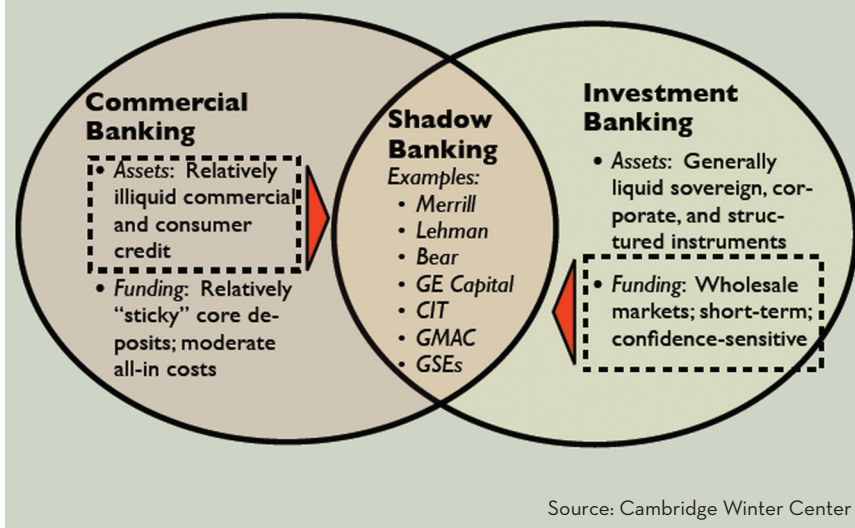
FINANCIAL SECTOR ASSETS



Source: Federal Reserve Board, Flow of Funds; Department of Commerce (Bureau of Economic Analysts), National Income and Products Table 1.1.5

FIGURE 2

SHADOW BANK DEFINITION



well the inherently illiquid nature of credit-intensive commercial and consumer loans.

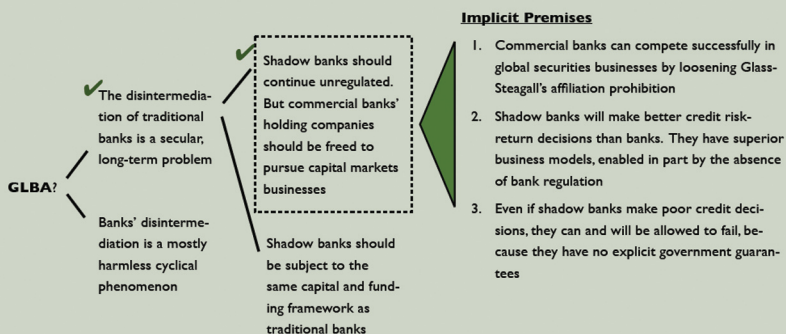
Investment banking is a very different business. Such firms underwrite securities and make markets in them. Given those activities, their assets tend to disproportionately comprise relatively liquid inventories of corporate and government securities. Investment banks favor inexpensive, short-term funding in the wholesale markets. This funding derives from relatively few institutional sources, many of which depend on credit rating agency judgments. Investment banks lack the same kind of resilient retail funding that marks commercial banks, but the pure investment banking business model, given its asset-liquidity, does not need it.

Shadow banks, then, exist at the intersection of commercial bank-like assets (that is, credit-intensive and illiquid), and investment bank-like liabilities (that is, whole-sale, short-term, and confidence-sensitive). A variety of non-bank firms – investment banks, mortgage REITs, finance companies, the housing GSEs – fall within this definition.

Before GLBA, and on into the credit bubble, shadow banks could secure funding at lower cost than commercial banks, while constructing similar asset portfolios. This funding advantage over banks was often compounded by a leverage advantage, as credit rating agencies, for many asset classes, required less capital support than would be required by bank regulators. With both funding and capital advantages in hand, shadow banks grew to more than half of the U.S. financial system.

FIGURE 3

GLBA LOGIC TREE (1999)



Source: Cambridge Winter Center

IMPACT ON BANKS

In many of the commercial banks' core asset classes, high-quality borrowers left them in favor of lower-cost capital market and shadow bank alternatives. Investment grade corporate clients, for example, increasingly sought short-term financing in the commercial paper markets.⁴ Prime mortgage borrowers were increasingly captured by the growing portfolios of Fannie Mae and Freddie Mac.⁵ Prime auto finance customers shifted to the captive finance arms of manufacturers. The high-margin consumer credit card business, as well as subprime auto lending, moved to monoline finance companies that were generally funded through off-balance sheet asset-backed securities.

Because of these shifts in market share, deposit-funded commercial banks became ever more concentrated in those asset classes that were relatively ill-served by the capital markets — particularly higher risk middle-market commercial loans, small business loans, and commercial real estate finance.

In other words, the asset portfolios of insured depositories had been steadily forced by non-bank competition into the most risky, most volatile corners of the business.

GLBA'S THREE PREMISES

Faced with what seemed to be a secular reduction in banks' profitability, and an increase in banks' risk, policymakers had, logically, two broad options: (a) prevent non-banks from encroaching on traditional bank businesses; or (b) allow banks to compete in the markets that were steadily stealing banks' market share. GLBA was an emphatic endorsement of the second approach, and a rejection of the first. Such a policy choice implicitly rested on three logical premises. (See Figure 3).

The first premise is that by allowing commercial banks to affiliate themselves

with investment banks, they would retain client lending business that otherwise would be captured by the shadow banking system. In theory, as traditional commercial bank clients increasingly accessed the capital markets for their funding, instead of relying on bank credit, the banks themselves would be able to help arrange that capital market financing, and collect fees as a result. Although those securities businesses might be high-risk, that volatility would be kept separate from the actual deposit-taking legal entities, and housed in affiliates of the banks' holding companies.

Second, policy-makers had implicitly assumed that non-banks were taking share from banks because they were fundamentally better business models. That is, non-banks were making better risk-return decisions, because they were free from regulatory burdens, and flexible enough to embrace product and technological innovations rapidly.

Third, and crucially, GLBA was premised on the notion that because non-banks did not rely on insured deposits, even if the crucible of free market discipline somehow resulted in imprudent risk-taking, those risks would not result in systemic or taxpayer harm.

EVALUATING GLBA'S PREMISES

With the benefit of hindsight, the three premises underpinning GLBA's key choice – allowing bank holding companies to pursue non-bank activities, instead of regulating non-banks' banking activities – proved to be almost completely false.⁶

GLBA did not make most banks more competitive.

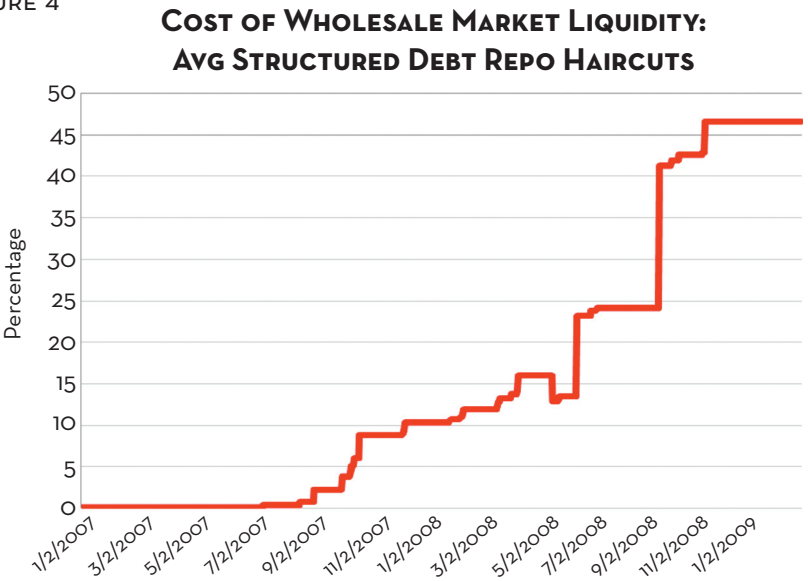
The opportunity to participate in the investment banking business has provided virtually no benefit to the vast majority of commercial banks. The global securities business requires substantial scale and scope to compete credibly. With the exception of only a few bank holding companies (like Citigroup, which, not coincidentally, pressed hard for GLBA), most banks are simply too small or geographically limited to be relevant in the core investment banking businesses. For the vast majority of regional and community banks, the theoretical availability of the securities business has been wholly irrelevant.

Most banks did not become more profitable or efficient as a result of GLBA. More likely, the reverse is true. As discussed below, GLBA instead left intact the ability of shadow banks to compete in traditional commercial bank businesses – that is, to take credit and interest rate risk as though they were banks – which further compressed bank profitability.

Shadow banks made systematically distorted, pro-cyclical credit decisions.

GLBA's second tacit premise – that lightly regulated non-banks could be better credit and rate intermediaries than regulated banks – has also proved inaccurate.

FIGURE 4



Source: Gorton and Metrick (2009)

In hindsight, the reason that “shadow banks” were able to out-compete traditional banks so thoroughly during the credit bubble is not due to better business models, but rather due to structural features that were decidedly pro-cyclical. Pro-cyclical features are disproportionately successful during credit bubbles.

Absent bank-like prudential regulation, shadow banks’ credit decisioning, capital levels, and funding costs were all driven by the same general kinds of necessarily backwards-looking, data-driven models. Such models, unfortunately, tend to predict the most optimistic credit results, the lowest required capital levels, and the lowest funding costs, at precisely the wrong time: at the end of a long, benign credit cycle.

In other words, the very capital and funding arbitrage that allowed shadow banks to underprice risk and gain share during the bubble also ensured correspondingly devastating results in the crisis.

Taxpayers were forced to rescue the shadow banking system.

Finally, the third logical premise supporting the shadow banking system proved inaccurate as well: despite shadow banks’ lack of substantial deposit insurance,⁷ or other explicit taxpayer backing, policymakers stepped in to prop up the shadow banking system as it failed.

An inherent feature of shadow banks is the immense scalability of their balance sheets. They are not subject to bank-like prudential regulation that might serve as a governor on their growth. They need not compete, slowly, customer by customer, for deposit funding, because they rely almost exclusively on wholesale

FIGURE 5

SHADOW BANK BAILOUTS

		DIRECT GOVERNMENT RESCUE			
		CHARTER CHANGE	CAPITAL INFUSION	DEBT GUARANTY	ASSET GUARANTY
INVESTMENT BANKS	GOLDMAN	X	X	X	
	MORGAN STANLEY	X	X	X	
	MERRILL		X		X
	BEAR				X
	LEHMAN				
FINANCE COMPANIES	GE CAPITAL			X	
	GMAC	X	X	X	
	CIT	X	X		
	AMEX	X	X	X	
	DISCOVER	X	X	X	
GSE'S	FANNIE MAE		X	X	
	FREDDIE MAC		X	X	

Note: Merrill and Bear asset guarantees refer to credit protection on their portfolios provided to their respective acquirers, Bank of America and JP Morgan, to acquire their firms. Their acquirers also availed of FDIC-provided debt guarantees, but probably would have even without the deals.

Source: The companies; SIGTARP

funding markets instead.

So the shadow banks – the firms most willing and able to underprice risk during the bubble – also had the best ability to fund explosive loan growth. By the time of the crisis, the result was a collection of non-banks with extremely large balance sheets, which included substantial positions in illiquid consumer and commercial loans, funded mostly by short-term capital market funding.

Unfortunately, when very large, capital market-funded firms suffer credit deterioration, ripple effects in the global capital markets can be severe. Shadow banks’ broker-intermediated, model-driven origination engines generate adversely selected loans during the benign phase of the credit cycle. Those loans then suffer disproportionately as the cycle turns. Wholesale funding begins to tighten in the face of mounting credit losses, and the resulting liquidity squeeze forces highly leveraged shadow banks to sell assets at depressed levels. This causes asset prices to decline, which in turn causes wholesale market secured creditors to tighten funding terms even further. (See Figure 4).

The result is a quickly deteriorating cycle of forced de-leveraging: a classic banking panic – but in the shadow banking system.⁸

This dynamic created the very real potential for full-scale runs on money market funds, and the attendant shutdown of the commercial paper markets. More

than any other factor, the potential real economy havoc created by such a shut-down helped drive policymakers towards a massive, unprecedented, and astonishingly expensive taxpayer bailout of shadow banks. (See Figure 5).

IMPLICATIONS

The loosening of Glass-Steagall prohibitions did not directly lead to the financial crisis of the past few years. But by focusing on the deregulation of banks, instead of managing the already growing systemic risk of shadow banks, the late 20th Century financial reforms may well have enabled the crisis.

Absent two broad-based repairs to financial regulation, it might well be impossible to reestablish a functioning shadow banking market. First, the moral hazard reinforced by the serial rescues of shadow banks must be dampened through the adoption of a credible resolution regime for systemically important firms. Second, a rationalized structured credit market (e.g. one with appropriate checks on the discretion of issuer-paid rating agencies) is a prerequisite for a resilient shadow banking system. Structured credit, after all, is the principal means by which shadow banks take credit and interest rate risk.

If those broad-based reforms are made, then policymakers may go on to tailor a new Glass-Steagall regime – one that suited to the 21st Century:

1. Create prudential regulation for systemically important shadow banks. As recent events painfully illustrate, large non-banks that have substantial shares of wholesale funding markets create disruptive ripple effects when they fail. Such effects are at least as disruptive and as expensive to taxpayers as the failure of depositories. At minimum, such shadow banks should be subject to the same limits on risk-taking as banks. Indeed, given such firms' deep interconnection within wholesale funding markets, limitations on credit-intensive asset concentrations and proprietary trading might even be made more stringent than for banks.
2. Eliminate shadow banks' capital arbitrage. In a similar vein, systemically important shadow banks should be subject to the same capital standards as banks. Allowing disparate capital frameworks encourages capital to migrate to the most permissive regime. That, in turn, encourages distorted, pro-cyclical credit allocation.
3. Eliminate shadow banks' funding arbitrage: Stress test liquidity positions. The crisis has underscored the fragility of shadow banks' funding model, which relies on confidence-sensitive wholesale markets to support credit-intensive assets. For systemically important shadow banks, at least, regulators should stress test liquidity buffers in multiple, simultaneous dimensions, including asset-liquidity stresses (e.g. assume no sales of structured credit without a 40% haircut for 6 months); funding market stresses (e.g. assume sub-AAA unsecured markets are shut for 12 months); and yield curve stresses (e.g. immediate long-end increase by 100 bps, short end increase by 300 bps).

Policymakers stood silent through decades of the shadow banks' emergence as a distorting and destabilizing force in the U.S. financial system. A renewed approach to Glass-Steagall, informed by the lessons of the crisis, could address that problem at long last.

ENDNOTES

1. It is not wholly accurate to claim, as is commonly the shorthand, that GLBA repealed Glass-Steagall. Rather, GLBA allowed commercial banks and securities firms to become affiliated with each other, but kept other prohibitions in place. See Peter Wallison, "Deregulation and the Financial Crisis: Another Urban Myth", American Enterprise Institute Outlook Series, text accompanying notes 6-9 (October 2009). Of course, even GLBA's sponsors appeared to believe that they were repealing Glass-Steagall, so the confusion today, more than 10 years later, is not especially surprising. Senate Banking Committee, Press Release: "Gramm Closing Floor Statement on Gramm-Leach-Bliley Act of 1999" (November 4, 1999) ("Ultimately, the final judge of the bill is history. Ultimately, as you look at the bill, you have to ask yourself, 'Will people in the future be trying to repeal it, as we are here today trying to repeal – and hopefully repealing – Glass-Steagall?' I think the answer will be no").
2. See Gary B. Gorton, "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007", Federal Reserve Bank of Atlanta 2009 Financial Markets Conference, pages 23-31 (May 9, 2009) (describing potential drivers for the growth of shadow banks); Perry Mehrling, "The Global Credit Crisis, and Policy Response", pages 3-10 (May 30, 2009) (describing role of AAA structured credit and money markets in growth of, and liquidity risk in, shadow banking), available at http://cedar.barnard.columbia.edu/faculty/mehrling/Global_Credit_Crisis_and_Policy%20Response.pdf
3. Even independent, atomized, insured depositors can panic, of course, if the threat of catastrophic collapse is sufficiently severe and well-publicized. The experience of Indy-Mac, Washington Mutual, and even Wachovia during the credit crisis makes that clear. But most banks did not experience runs, despite the deep, wide-spread credit deterioration during 2007 through 2009.
4. Commercial paper is essentially short-term debt issued by corporations and bought by institutional investors. Commercial paper investors typically are not willing or able to retain credit risk, so the market is dominated by issuers that carry the highest short-term credit ratings. Because the debt is short-term, large corporate borrowers are faced with the practical need to continually "roll" or refinance their commercial paper as it matures.
5. For a more detailed overview of the GSEs' role in the credit bubble and crisis, see Raj Date, "The Giants Fall: Eliminating Fannie Mae and Freddie Mac", Cambridge Winter Center (March 3, 2010).
6. This is not meant as a criticism. Policymakers' perspectives, in 1999, were understandably colored by a long period of relative economic stability and growth. In general, forward-looking estimates of risk (by legislators and market participants alike) tend to decline during periods of prosperity.
7. Shadow banks, definitionally, are not deposit-taking institutions. But the availability of a loophole in the Bank Holding Company Act allowed non-banks to own certain state-chartered depositories, called industrial loan companies, without subjecting the parent firm to consolidated regulation by the Federal Reserve, and its attendant capital requirements. GLBA expanded that loophole to include ownership by investment banks. That appealed to the largest Wall Street firms, which could now use ILCs to diversify their funding bases with insured deposits, but without having to hold bank-like capital levels. By the onset of the crisis, almost 90% of the nation's ILC assets were in a single state, Utah, and almost two-thirds of those Utah assets were held by subsidiaries of just five Wall Street investment banks: Merrill Lynch; Morgan Stanley; Lehman Brothers; Goldman Sachs, and UBS. See Raj Date, "Industrial Loan Companies and Shadow Banking", Cambridge Winter Center (August 10, 2009).
8. See generally Gorton, *supra* note 3; Mehrling, *supra* note 3, at pages 14-15.

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The views expressed in this paper are those of the authors and do not necessarily reflect the positions of the Roosevelt Institute, its officers, or its directors.

SECURITIZATION

TAMING THE WILD WEST

Joshua Rosner

Between 1989 and today, securitization markets, and therefore the capital markets, have replaced banks as the lead funding for home mortgages. It is true that excessive social engineering to over-stimulate housing purchase drove speculation. But in my view, poorly developed and opaque securitization markets drove excessive liquidity and irresponsible lending and borrowing. Without the confluence of these issues we would not have had the withdrawal of liquidity to the mortgage finance market and an ongoing cycle of falling home prices. This opacity is the actual root of the crisis, and it led to the ultimate breakdown of the private securitization market.

Today, as it was in the prelude to the crisis, securitization markets too often operate in a “Wild West” environment where the rules are more often opaque than clear, standards vary, and useful and timely disclosures of the performance of loan level collateral is hard to come by. Asymmetry of information, between buyer and seller, is the standard.

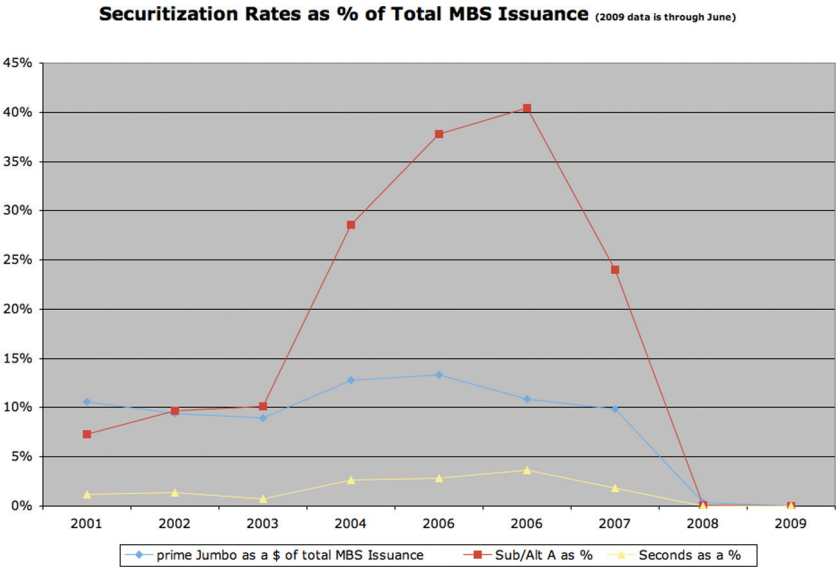
Current problems in the real economy, stemming from the opacity and information asymmetry of the asset backed securities (ABS) market, are not isolated to private first-lien residential mortgage securitization markets. They extend to other areas of consumer financing, like home equity, cards, and auto. They also involve commercial financing, like commercial mortgages, construction loans, bank trust preferred, corporate loans, and commercial paper. However, because of the excessive degradation of mortgage underwriting standards and the growth in mortgage funding, we have seen the earliest and most serious damage in this sector. Consider the scale of this growth: between 1985 and 2007 the ABS market grew dramatically, from \$1 billion in new issues to \$997 billion in new issues. (See Figure 1.)

To believe that real estate or the economy itself can find a self-sustaining recovery without first repairing this important tool of financial intermediation is unrealistic. Liquidity cannot efficiently find its intended target unless there are credible markets in which participants can foster financial intermediation and through which capital can be transmitted. Expanding the monetary base without an effective means of financial intermediation can result in little more than hoarding. Other than fostering new asset bubbles, it may have little sustainable productive economic impact.

REPAIR AND RESTRUCTURING

Since 2007, those parts of the securitization market that are not fully subject to implicit and explicit subsidies or guarantees by governments, or do not have robust standards, have ground to a virtual halt. We must set about to fundamentally repair them. These repairs are achievable, but they must be real and fun-

FIGURE 1



Source: Inside MBS and ABS

damental. They cannot be merely another iteration of the same flawed market with the same skewed incentives. Investors -- the key intermediaries in capital formation -- need to lead the redesign. They cannot be subject to information asymmetries, fee-arbitrage opportunities and other structural flaws imbedded in the issuer-led design of the prior securitization markets.

While the economy has, for the moment, exited recession, the risk remains that without functioning securitization markets, many of the credit constrained assets formerly funded by securitization will continue to follow the housing market in collateral value declines.¹

If it is correct that the real economy problems with housing are not the root of the crisis, then many of the problems in the real economy which stem from contraction in credit availability may be symptomatic of securitization market failures. There is an immediate need for regulators and policymakers to oversee the creation of a standardized market where assets can be securitized, priced, valued and consistently evaluated by investors. In recreating the structured market, we must also clear outstanding legal questions^{2,3,4} about matters such as “true sale”.^{5,6} Without clarifying the clear legal and accounting standards on “true sale”, issuers of a securitization may retain rights to or responsibility for collateral that they thought they sold and the investor in a pool believed himself to have purchased.

The primary market for securitizations is different from the equity markets. There is no “red herring” or pre-issuance road-show period during which investors have the ability to really analyze a deal and its underlying collateral. Typically, deals come to market so quickly that investors are forced to rely on rating

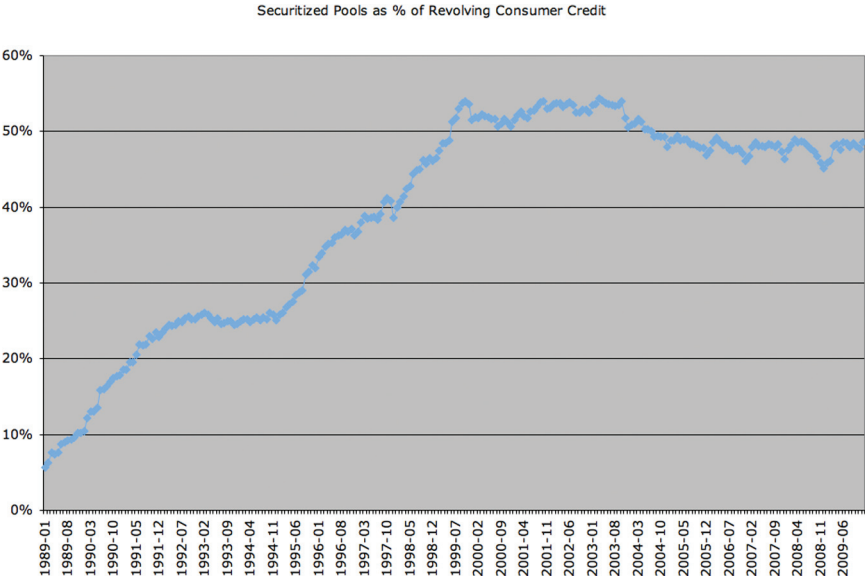
agency pre-issuance circulars, term-sheets or weighted average collateral data. These tools have proven inadequate.

In order to accurately price securities, investors need timely loan-level performance data on the assets backing each deal. We need loan-level data on a daily, or at least monthly, basis in both the primary and secondary markets.

Without frequently updated and standardized disclosure of loan-level data, market participants can't independently analyze and credibly value asset-backed securities based on full information. Previously, investors didn't know what they were buying. Currently, investors are staying away from the securitization market. A massive withdrawal of funding to key parts of our economy is the unfortunate result.

The parts of the private issuer securitization market that are governed by the SEC's "Regulation AB" are currently functioning more fully than those not subject to reporting and disclosure requirements of "Reg AB". Where many non-revolving collateral class securitizations have ground to a complete halt, credit card and auto securitizations continue to function, though some at a lower level because of concerns about the quality of consumer credit in the real economy.

FIGURE 2



Source: The Federal Reserve

THE NEED FOR DISCLOSURE

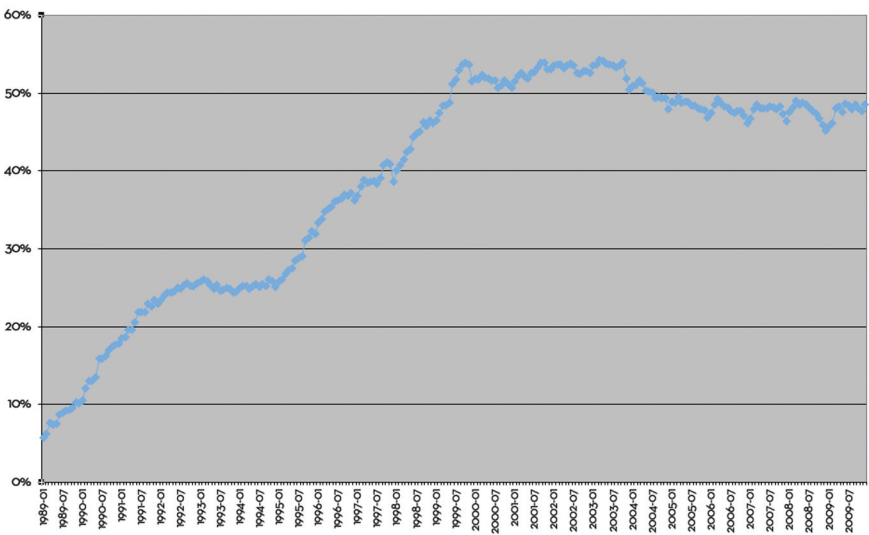
To ensure adequate transparency, enhanced disclosure rules should be required both for deals with and without static pool data (such as asset backed commercial paper). Data on the specific underlying collateral in each pool should be made available for a reasonable period (not less than two-weeks) before a deal is sold and brought to market. This should be done to enhance investor due diligence, to foster the development of independent analytical data providers, and to reduce reliance on rating agencies. The loan-level data should be available in an electronically manageable and standardized format.

While full elimination of the rating agencies may or may not be necessary or realistic, in my opinion we must reduce reliance on ratings and support a narrowing spread between price and value in the secondary market. To that end, the SEC should require that after the deal is sold, all data fields in the pre-issuance disclosures and material information about the loan level collateral in the pool should be updated and be similarly disclosed on a daily, or at least monthly, basis in an electronically manageable and standardized format. Regardless of the nature of the deal (private placement or registered) the data should be publicly disclosed to the loan level and all servicer advances to the pool shall be disclosed as such on a timely basis. Any subsequent repayments of servicer advances should also be reported in a clear manner.

Capital and markets would be less volatile if they could fully model the expected performance of underlying loan level collateral data before a deal comes to market and, on a regular basis, reassess the deviance from expectation. The regular and timely updates to collateral data would reduce volatility, since degradation in a pool would be observable and thus priced in over incremental

FIGURE 3

Securitized Pools as % of Revolving Consumer Credit



Source: The Federal Reserve

periods. By requiring that investors receive early and regular disclosures of all available data and adequate levels of information about the underlying collateral, the importance of rating agencies' recommendations will be diminished to the level of an equity analysts' research note.

Rather than recognize this lack of timely loan-level performance disclosure standards, regulators and legislators have been pushing to require issuers to hold a slice of every deal they issue. On the surface, this appears to make sense. But on closer examination, that requirement would not have prevented the past crisis and it probably won't prevent the next one. Many of the firms that have been harmed by holding these securities were the same firms that issued them. The retention argument comes from the belief that issuers may have knowingly sold toxic securities. But more often, these firms didn't have the available information or resulting ability to fully model their exposures. To force them to increase concentrations of these held securities will only increase their risks.

If detailed loan-level performance data were provided, investors could properly analyze risks to the pool. In that environment, prohibiting retention would actually reduce the risks to our regulated financial institutions, because the problems faced by Merrill, Bear, and others resulted directly from retained exposures to tranches of securitizations they thought were appropriately risk modeled – and turned out not to have been.

In the lead-up to the crisis, even primary financial regulators could not analyze or even have access to deal documents of CDOs their regulated institutions held.⁷ The automation, standardization, and public disclosure of key collateral information before a securitization is marketed – and at least monthly after it is sold – is a necessary ingredient to the development of the deep and broad markets necessary to fund our economy.

In further support the ongoing development of deep and broad markets and reduce the gaming of mark-to-market values, the SEC should require that, on a daily basis, all dealers publically disclose the last trade prices of all ABS, regardless of whether they are otc, bespoke or registered.

CONTRACTS THAT WORK

We also need to address the lack of uniformity in the contractual obligations between various parties to a securitization. “Pooling and Servicing Agreements” (PSAs) and “Representations and Warranty” terms can be several hundred pages long. They define features like the rights to put back loans that had underwriting flaws, the responsibilities of servicers, and the relationship between the different tranches. In addition, key terms that define contractual obligations are not standardized across the industry, across issuers of securities with the same type of collateral (e.g. RMBS, CMBS or RMBS based CDOs) or even by issuer (each issuer often had several different Pooling and Servicing Agreements and Representation and Warranty Agreements).

The lack of standardization and the length of the documentation effectively created opacity, which contributed to the problems in the securitization market. When panic set in and investors began to question the value of their securities, they knew that they did not have the time to read all of the different several-hundred page deal agreements. This reinforced the rush to liquidate positions. What investor wants to be the last one holding a security whose terms he doesn't fully understand?

This “run on the market” caused securities’ values to fall further than fundamentals would have justified. But without clarity of contract or sufficient, frequently updated, loan-level information to readily analyze the underlying collateral values, there was no other possible outcome. As a result, even investors that focused on distressed securities could not identify, analyze and invest in these securities in the timely manner necessary to provide a floor under prices.

The industry has only recently moved to create standardized PSA and Rep and Warranty agreements for various collateral asset classes. But the efforts have been quite slow and are amazingly inadequate.⁸ The industry efforts have been led by sell-side dominated industry trade groups consisting of dealers, issuers, rating agencies, bond insurers, private mortgage insurers and, to a much lesser degree, investors.

While these efforts could be seen as a step in the right direction, it is clear they have forged no meaningful agreement and have offered little – if anything – by way of standards.⁹ Instead, legislation should direct regulators to create a single standardized Pooling and Servicing Agreement governing each collateral asset class whether the issued securities are registered or “over the counter” or “bespoke”. These agreements should be created with the best interests of the investing public, and clarity of contract, at their cores.

WHY STANDARDS MATTER

Legislative and regulatory standard setters must also focus on addressing a lack of clear definitions in securitization markets. Without a common language and agreement on the meanings of fundamental concepts the value of data is diminished. Conversely, if everybody is using common language – in loan origination or securitization – then it becomes very hard to game the system. The lack of clear definitions remains a huge problem that interferes with investors’ ability to compare performance of various deals and issuers and analyze and assess the true performance of the underlying collateral.

Amazingly, three years after a crisis, there is still no single standard accounting or legal definition of either delinquency or default. The entire purpose of accounting standards and securities law is to provide a framework for comparability. Yet we still do not have a single and accepted definition for so many of the key credit measures.

Currently, the term ‘delinquency’ can be determined either on a contractual or

recency-of-payment basis. Even among firms that would define it on the same basis, each servicing agreement can have different interpretations of the reporting of delinquencies. Some may report advances that a servicer makes to a pool, which could be applied to reduce stated delinquencies. But other servicers may not.

How can either issuer or investor clearly understand whether they owe a duty to the other if there is so much variability from deal to deal and are no industry standard practices? Like so many of the underlying problems in the securitization market, this “Wild West, new frontier” mentality needs to be replaced with agreement of terms and standards. When no one agrees on the definition of delinquencies and or on how they must be reported, then we get a lack of standards on the definition of defaults. This leads us back to a world in which the complexity of contract is endemic to each deal and reduces the viability of securitization markets.

THE PROBLEM OF THIRD PARTY ORIGINATORS

Further complicating problems in the residential mortgage securitization market is the involvement of third-party originators of mortgages who are not always directly included as party to the securitization process. For example, assume that ABC Mortgage Company originates mortgage loans and sells those to XYZ Bank, which, in turn, directly or indirectly securitizes those loans. Assume ABC made representations to XYZ that were untrue, and XYZ made those representations to the investors in the securitization. And further assume that the representation and warranty agreement between XYZ (as issuer) and the investor stated that the bank would have to buy back any misrepresented loans. If XYZ had a separate agreement with ABC that required it to buy them back, in turn, from XYZ, then a larger problem could arise if the unregulated – and possibly under-reserved and undercapitalized – ABC did not have the funds to buy them back.

Over the past several years, we have heard regulatory claims that many of the problems in mortgage markets stem from the mortgages originated by unregulated third party originators. This is an unacceptable cliché that must be replaced with clear standards. If an issuer purchases mortgages from, or sponsors securitizations by, third party originators, then certain things must happen. They must be made to warrant that the originations meet their own stated underwriting criteria. And they should be required to expressly recognize any underwriting liability for any collateral purchased from third parties that does not meet their own underwriting standards. This would result in regulated financial institutions becoming responsible for ensuring their own due diligence of third party or affiliate lenders.

Simply, we need standards that transfer credit and liquidity to investors, but place underwriting risk with the issuer for specific period of time tied to the final closing of the collateral pool (after any revolving period) and linked to resets and amortization of loan specific types of collateral. If, for example, that period

is one year, issuers should set up reserves against the risk of underwriting errors and servicers and investors should understand that after a year, they will no longer have the ability to put back loans for underwriting flaws unless the flaw involves fraud and it is specifically demonstrable that the fraud was directly correlated to a default.

COLLATERAL SERVICING

When a pool of first lien mortgages is created and sold into a trust, a servicer is chosen to service the loans, collect the mortgage payments and direct the cash flows to investors as defined in their agreements. While investors in different tranches to the securitization may not always have aligned interests, in light of the significant numbers of mortgages today that have negative equity (close to 50%), most of the remaining holders would be willing to write down the principle balance of the loan if they would result in reperformance of collateral. For example, assume a 20% reduction in the principal balance of a mortgage would result in a borrower becoming willing and able to make payments and become current again, on a sustainable basis. This 20% loss, though significant, would surely be preferable to the potential 60% loss investors could experience upon default and a subsequent foreclosure.

Unfortunately, due to an ill-defined legal relationship between service and investor, along with a large and common conflict of interest between the servicer and the parent companies that own most of the servicers, many servicers would not prefer this “less is better than nothing” approach. Many of the servicers are owned by the largest banks -- banks that often hold the second liens or home equity lines on the underwater houses. Remember, the second lien is, by definition, subordinated to the first lien. So if the servicer wrote down the principal on the first lien, it would, where the mortgagee is in a significant negative equity position, completely wipe out the value of the second lien and cause the bank to experience a total loss on that loan.

Because of the lack of a fiduciary obligation to the first lien holder, the servicers are often motivated to protect their firm's second lien positions, rather than the first lien holders'. And because of the way the servicing agreements are written, servicers are often able to justify their inaction by hiding behind the disparate obligations they owe to investors in different tranches. Alternatively, they are able to do so by using a “net present value test” that is based on projections of unknowable future scenarios. As a result, both investors and the troubled borrower are held hostage to servicing practices that seek to protect often under-reserved banks rather than act on their expected obligation to investors in the mortgage pool. New rules in securitization should clearly define the servicer as a owing a fiduciary duty to the investor in securitized pools. Or perhaps more effectively, it should specifically prohibit financial entities from owning servicing where the servicing results in a conflict.

CONCLUSION

Securitization has shifted significant funding for many asset classes away from

bank balance sheets and into the hands of capital markets participants. With appropriate standards, securitization would more efficiently fund markets and cause a less volatile and closer convergence between the pricing and value of assets in support of economic activity and productive growth. This change is the reason that we must now restart the securitization markets.

If they are not functioning as an alternative to portfolio lending, where economically less expensive, then there is no way to finance an economy that has previously been funded by the global capital flows through capital markets. Financial institutions do not have the balance sheet capacity to directly support all or a substantial proportion of the credit previously provided by the capital markets. A failure to foster this intermediation external to the depository system will risk an ongoing shrinkage of market funding for economic activity. This, in turn, will precipitate greater bouts of deflation as access to credit remains highly constrained.

Securitization has served as a critical tool of intermediation and must be revived or replaced with a more viable tool if we are to maintain the lending capacity required by our modern economy. Functioning securitization markets, cured of information asymmetry and misaligned incentives, could help to stabilize the present situation.

While there are other areas of further changes that may be worth considering – including structuring standards and pricing and valuation enhancements which could ultimately allow securitization tranches to trade on exchanges and behave similarly to closed end funds – the recommendations in this paper are fundamental precursors to financial intermediation and must be implemented as standards for securitization or its alternatives (such as the immature covered bond market).

ENDNOTES

1. See Joseph R. Mason & Joshua Rosner, *How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?*, Working Paper, Feb. 15, 2007 [hereinafter Mason & Rosner February 2007], at 33 (“We therefore maintain that the shrinkage in RMBS sector is likely to arise from decreased funding by the CDO markets as defaults accumulate. Of course, mortgage markets are socially and economically more important than manufactured housing, aircraft leases, franchise business loans, and 12-b1 mutual fund fees. Decreased funding for RMBS could set off a downward spiral in credit availability that can deprive individuals of home ownership and substantially hurt the U.S. economy. As described in detail in section II.A, the CDO market adds liquidity to the RMBS market in a highly leveraged fashion by funding lower-tranche MBS securities, and the experience of the ABS markets in the early 2000s illustrates that the liquidity provided by CDOs is very fragile.”).
2. Lois R. Lupica, Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic, 9 *Am. Bankruptcy Inst. L. Rev.* 287, 293 (noting that asset backed securities have grown from a relatively insignificant \$1 billion market in 1985).
3. See, e.g., Jessica L. Debrun, Recent Developments in and Legal Implications of Accounting for Securitizations, 56 *N.Y.U. Ann. Surv. Am. L.* 367, 382 (1999), available at: [http://www.law.nyu.edu/pubs/annualsurvey/documents/56%20N.Y.U.%20Ann.%20Surv.%20Am.%20L.%20367%20\(1999\).pdf](http://www.law.nyu.edu/pubs/annualsurvey/documents/56%20N.Y.U.%20Ann.%20Surv.%20Am.%20L.%20367%20(1999).pdf) (“The Tenth Circuit in particular has been highly criticized, though not yet reversed, for its decision in a case involving true-sale analysis.

Faced with a sale of accounts, the court in *Octagon Gas Systems, Inc. v. Rimmer* applied the provisions of Article 9 of the UCC to determine that the transaction constituted a security interest rather than a true sale.”).

4. See Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions*, Working Paper, May 2007, available at: www.hudson.org/files/publications/Hudson_Mortgage_Paper5_3_07.pdf, at 34 p.34 (“See: “In December 2000, LTV Steel filed for voluntary Bankruptcy protection under Chapter 11 in the US Bankruptcy Court of Northern Ohio 121. In their filing the Company asked the court to grant an emergency motion to allow them to use the collections from the securitizations and claimed that the transactions were not “true sales” but rather “disguised financings”. The Court granted the Company’s motion though it did not rule whether or not the securitizations were “true sales”. ... In fact, one of the agencies appeared to pressure attorneys to avoid commenting on the matter in legal opinions. “Standard & Poor’s insisted that attorneys submitting true-sale opinions to the rating agency stop referring to LTV, noting that the court never made a final decision and that such citations inappropriately cast doubt on the opinion. Seven months later, in a delicately worded press release, S&P withdrew that prohibition—apparently because lawyers refused to ignore such an obvious legal land mine.”) [hereinafter Mason & Rosner May 2007].
5. See, e.g. BMeyer, *Countrywide Mortgage settles with Ohio, 7 others*, Oct. 6, 2008, available at: http://www.cleveland.com/nation/index.ssf/2008/10/countrywide_mortgage_settles_w.html (Author’s note: If the Company has the right to enter into a settlement, for its benefit, and make commitments of third party investors in a supposedly legally isolated Trust, then it appears this action may again open the unresolved legal question of whether a securitization could ever be legally treated as a “true sale” as opposed to a disguised financing.)
6. See Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions*, Working Paper, May 2007, (see: “In December 2000, LTV Steel filed for voluntary Bankruptcy protection under Chapter 11 in the US Bankruptcy Court of Northern Ohio 120. In their filing the Company asked the court to grant an emergency motion to allow them to use the collections from the securitizations and claimed that the transactions were not “true sales” but rather “disguised financings”. The Court granted the Company’s motion though it did not rule whether or not the securitizations were “true sales”. Although this case could have caused the rating agencies to take the same position as the Georgia law, of ambiguity making it difficult to rate the risks to noteholders they chose not to. In fact, one of the agencies appeared to pressure attorneys to avoid commenting on the matter in legal opinions. “Standard & Poor’s insisted that attorneys submitting true-sale opinions to the rating agency stop referring to LTV, noting that the court never made a final decision and that such citations inappropriately cast doubt on the opinion. Seven months later, in a delicately worded press release, S&P withdrew that prohibition—apparently because lawyers refused to ignore such an obvious legal land mine.” 121”)
7. See Joseph R. Mason & Joshua Rosner, *How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?*, Working Paper, Feb. 15, 2007 p.36 (See: Perhaps of greater concern is the reputational risk posed to the U.S. capital markets—markets that have historically been viewed as among the most transparent, efficient, and well regulated in the world. The economic value of mortgage securitization and the risk transfer value of CDO issuance support their further use. However, there should be significant resources allocated to building the regulatory framework surrounding their structuring, issuance, ratings, sales, and valuation. We believe that efforts to provide transparency to these new product areas can foster stability while maintaining liquidity to the underlying collateral sectors and supporting further meaningful financial innovation and capital deepening. At present, even financial regulators are hampered by the opacity of over-the-counter CDO and MBS markets, where only “qualified investors” may peruse the deal documents and performance reports. Currently none of the bank regulatory agencies (OCC, Federal Reserve, or FDIC) are deemed “qualified investors.” Even after that designation, however, those regulators must receive permission from each issuer to view their deal performance data and prospectus’ in order to

monitor the sector.)

8. See: http://www.americansecuritization.com/uploadedFiles/ASF_Project_RESTART_Reps_and_Warranties_121509.pdf
9. IBID, p.7 (see: "Consistent with the other phases of ASF Project RESTART, the Model Reps were not created to encourage a regulatory or legislative mandate. Market participants believe that self regulation, through industry-wide consensus, is the most effective way to improve the securitization process. The Model Reps are not being released or adopted as an industry requirement nor are they meant to be a minimum standard for RMBS transactions or any regulatory purpose. Securitization transactions vary based on many factors, including the underlying collateral, the associated transaction parties, the types of bonds issued and the ultimate investors. The Model Reps provide a starting point in the negotiation process among issuers, investors and other transaction parties and should be considered living and flexible within a broad range of RMBS transactions.")

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BRING TRANSPARENCY TO OFF-BALANCE SHEET ACCOUNTING

Frank Partnoy and Lynn E. Turner

Abusive off-balance sheet accounting was a major cause of the financial crisis. These abuses triggered a daisy chain of dysfunctional decision-making by removing transparency from investors, markets, and regulators. Off-balance sheet accounting facilitated the spread of the bad loans, securitizations, and derivative transactions that brought the financial system to the brink of collapse.

As in the 1920s, the balance sheets of major corporations recently failed to provide a clear picture of the financial health of those entities. Banks in particular have become predisposed to narrow the size of their balance sheets, because investors and regulators use the balance sheet as an anchor in their assessment of risk. Banks use financial engineering to make it appear they are better capitalized and less risky than they really are. Most people and businesses include all of their assets and liabilities on their balance sheets. But large financial institutions do not.

Off-balance sheet problems have recurred throughout history, with a similar progression. Initially, balance sheets are relatively transparent and off-balance sheet liabilities are minimal or zero. Then, market participants argue that certain items should be excluded as off-balance sheet. Complex institutions increase their use of off-shore subsidiaries and swap transactions to avoid disclosing liabilities, as they did during both the 1920s and the 2000s. Over time, the exceptions eat away at the foundations of financial statements, and the perception of the riskiness of large institutions becomes disconnected from reality. Without transparency, investors and regulators can no longer accurately assess risk. Finally, the entire edifice collapses. This is the story of both the 1920s and today.

As in the past, the off-balance sheet complexity and exceptions have gone too far. The basic notion that the balance sheet should reflect all assets and liabilities has been eaten away, like a piece of Swiss cheese with constantly expanding holes. Because off-balance sheet assets and liabilities were not included in financial statements, banks took leveraged positions that were hidden from regulators and investors. Because bank liabilities used to finance assets were not transparent, the financial markets could not effectively discipline banks that used derivatives and complex financial engineering to take excessive risks. Even if there are legitimate exceptions for items that might not belong on the balance sheet, those exceptions should not swallow the rule. Yet that is what has happened.

Congress should harness the power of free, well-functioning markets by requiring that banks include all of their assets and liabilities on their balance sheets. Transparency is one of the central pillars of a well functioning market. Congress recognized the importance of transparency in 1933 and 1934, when it imple-

mented a two-pronged approach to shine sunlight on the markets with (1) a requirement that companies disclose material facts, and (2) an enforcement regime for companies that do not make such disclosures. Now that the markets have once again swung too far away from transparency, Congress should implement a similar regime to require that (1) balance sheets are a clear picture of a corporation's financial health, and (2) there are consequences for companies that hide their debts.

Today, the problems associated with off-balance sheet accounting remain acute, despite efforts in the past decade by standard setters to improve transparency. The rules do not provide for sufficient transparency, and there is no effective enforcement mechanism. There is a lack of information regarding exposures to risks accompanying derivative transactions, and the potential impact on cash inflows and outflows. There is also a lack of information regarding how "interconnected" companies are to one another as a result of such transactions. As a result, even after the recent crisis, no one can get an accurate view of bank assets and liabilities. Too much exposure is buried within swaps and "Variable Interest Entities," known as VIEs. Financial reform proposals should promote the flow of information by requiring that companies report all of their assets and liabilities, including derivatives and VIEs, in a transparent, understandable way.

Here are our main recommendations:

- Companies must include swaps on their balance sheets.
- Companies must record all assets and liabilities of VIEs, in amounts based on the most likely outcome given current information.
- Companies must report asset financings on the balance sheet (not as "sales").
- Congress should adopt a legislative standard requiring such disclosures (mere "guidance" from the accounting industry is not enough).
- Companies that fail to disclose material facts should face civil liability.

OFF-BALANCE SHEET LIABILITIES

WERE AT THE CENTER OF THE RECENT FINANCIAL CRISIS

Off-balance sheet liabilities have been at the center of most recent financial crises, including the crisis of 2007-08. For example, in 1994, after the Federal Reserve raised short-term interest rates, losses on swaps and related derivatives shook the financial system, and regulators and investors were stunned to learn of hidden off-balance sheet bets on interest rates at dozens of funds and companies. Similar problems arose in 1997, when financial institutions disclosed off-balance sheet losses triggered by the devaluations of several Asian currencies. And then, of course, there was Enron, with off-balance sheet derivatives exposure that, as one of us testified at the first Senate hearings on Enron's collapse, "made Long-Term Capital Management look like a lemonade stand."

The most recent financial crisis was no different. Financial institutions built up hundreds of billions of dollars of exposure to subprime mortgage markets without disclosing these assets and liabilities on their balance sheets. The culprits

included both swaps and VIEs. For example, AIG disclosed only the “notional amount” of its credit default swaps, not the actual or potential liabilities associated with those trades. There was no warning in the AIG disclosures of the potential need for a bailout amounting to hundreds of billions of dollars. Similarly, major banks did not disclose their positions in super-senior tranches of synthetic collateralized debt obligations. Bank disclosures about swap and VIE exposures were incomplete and limited to footnotes. The officers and directors of these institutions have asserted that their disclosures were adequate, based on then-existing rules, though experts dispute those assertions.

In any event, it is now widely understood that these exposures generated the losses that crippled the banks. These swaps and VIEs were the instruments at the core of the crisis. And yet, as regulators and investors learned beginning in summer 2007, financial institutions had not included the money they owed pursuant to swaps and VIEs as liabilities in their financial statements.

Even today, the major banks continue to exclude trillions of dollars of swap and VIE liabilities from their balance sheets. More than a year after the height of the crisis, the balance sheets of financial institutions remain impenetrable. Significant liabilities are missing from their financial statements. Unlike the average person or business, banks continue to be permitted to keep many of their liabilities off-balance sheet.

Consider Citigroup as just one example. In its most recent quarterly financial filing, Citigroup described \$101 billion of “payables” based on credit derivatives. Those “payables” are a debt: Citigroup actually owes counterparties more than \$100 billion on these financial instruments. Yet that amount does not appear as an obligation on Citigroup’s balance sheet. To be sure, Citigroup has assets to offset this liability. And it does disclose its obligations in a footnote. But anyone who looks at Citigroup’s actual liabilities, as recorded in its financial statements, will not see these obligations. Importantly, regulatory risk and net capital formulas are based on financial statements, not footnotes.

Likewise, another footnote in Citigroup’s recent filing reports \$292 billion of “significant” unconsolidated VIEs. These VIEs are the nieces and nephews of Enron’s Special Purpose Entities, or SPEs. The VIEs have debts, but – like Citigroup’s swaps and other derivatives – the VIEs are referenced only in a footnote. They are not part of Citigroup’s actual balance sheet, and Citigroup does not record its interest in or maximum exposure to these entities.

Because banks do not report these assets and liabilities in any comprehensible way, regulators and market participants cannot understand the banks’ exposure to risk. Instead, the banks’ approach to off-balance sheet liabilities has made their financial statements virtually useless.

SWAPS PUSHED LIABILITIES OFF-BALANCE SHEET

The recent history of off-balance sheet accounting begins with swaps. Swaps

are private over-the-counter derivative transactions in which two counterparties agree to exchange cash flows based on some reference amount and index. The story of how banks lobbied to push swaps off their financial statements into the shadow markets should trouble any proponent of free markets.

This story began in the 1980s, when the derivatives market was relatively small and off-balance sheet transactions were largely unknown. The Financial Accounting Standards Board, the group that publishes most accounting guidance, suggested that banks should include swaps on their balance sheets.

The accountants' argument was straightforward. Banks already accounted for loans as assets, because the right to receive payments from a borrower had positive value. Banks already accounted for deposits as liabilities, because the obligation to pay depositors had negative value. A swap, the FASB argued, was no different: it was simply an asset and a liability paired together, like a house plus a mortgage, or a car plus a loan. (The asset part of the swap was the money owed by the counterparty; the liability part of the swap was the money owed to the counterparty.)

The FASB's premise was simple, common sense. When most people and businesses prepare financial statements, they list all of their actual assets and liabilities. The reason is straightforward: the government, creditors, and investors want to see the entire picture. Individuals and small business owners cannot hide some of their debts merely by relabeling them.

But banks foresaw that the burgeoning business of swaps would inflate the size of their balance sheets if they were reported as assets and liabilities. Banks wanted to profit from trading swaps, but they did not want to include swaps in their financial statements. Instead, they argued to the FASB that swaps should be treated as off-balance sheet transactions. In 1985, the banks formed a lobbying organization called the International Swap Dealers Association. That group, now widely known as ISDA, pressed the FASB to exempt swaps from the standard approach to assets and liabilities. The banks argued that swaps were different, because the payments were based on a reference amount that the swap counterparties did not actually exchange. ISDA was a forceful advocate, and the banks persuaded the FASB to abandon its argument.

ISDA and the banks have continued their lobbying efforts to keep swaps and other derivatives off-balance sheet, as they argued more generally for deregulation of these markets. As a result, banks and corporations that trade swaps do not play by the same rules as other individuals and businesses. Banks are permitted to exclude their full exposure to swaps from their financial statements, and instead report only the "fair value" changes in those swaps over time. Such reporting is like an individual reporting only the change in their debt balances, instead of the debts themselves.

THE “ALPHABET SOUP” OF SPEs AND VIEs

PUSHED LIABILITIES OFF BALANCE SHEET

The banks also lobbied for off-balance sheet treatment of deals using “Special Purpose Entities,” or SPEs. An SPE is a corporation or partnership formed for the purpose of borrowing money to buy financial assets.

Historically, under accounting rules adopted by the American Institute of CPAs, corporations were required to consolidate any SPEs they used to finance assets. During the 1970s, if a transaction was a financing, both the assets being financed as well as the financing had to be reported on the balance sheet. During the following two decades, the finance industry lobbied for changes that would permit them to avoid consolidating SPEs for many transactions. In general, the revised approach required that a corporation include the assets and liabilities of another entity in its financial statements only if it had a “controlling interest” in that entity. Importantly, the banks and Wall Street quickly sidestepped these rules by engineering transactions in which the sponsor did not have legal control, but still had economic control and would suffer losses from a decline in the assets’ value. The rationale was that if a bank did not have a legally controlling interest in an SPE, the liabilities of the SPE could remain off-balance sheet. The key question was: what was “control”?

That vexing question led many companies, most notoriously Enron, to create SPEs in which they held just a sliver of ownership, and – therefore, they argued – did not have control. Enron’s infamous Jedi and Raptor transactions were designed to take advantage of the so-called “three percent rule,” an accounting pronouncement that essentially permitted companies with less than three percent ownership of an SPE to keep the SPE’s assets and liabilities off-balance sheet. Enron arguably violated the “three percent rule” in many of its deals, but even the “rule” itself reflected the power of the banks over the regulators. The SEC’s chief accountant previously had expressed concerns about the abuses of SPEs and off-balance sheet transactions, but when the FASB delegated responsibility for addressing these concerns to its Emerging Issues Task Force, the result – after much lobbying – was a consensus among the major accounting firms in which they concluded that if outside parties put up just a mere three percent of the equity in the transaction, they could avoid treating the original sponsor as being in control.

Enron became the poster child of off-balance sheet liabilities, and the FASB responded to public outrage about Enron’s hidden liabilities by adopting FIN 46 and later a watered-down version called FIN 46(R), a new rule with a new acronym. FIN 46(R) recast the guidance on SPEs by creating a new definition of “Variable Interest Entity,” or VIE. The new guidance ostensibly was designed to limit the kinds of accounting shenanigans that had permitted Enron to hide so many liabilities. But FIN 46(R), like the earlier rules, continued to focus on “control.” In simple terms, if a bank did not have control of a VIE, it could keep that VIE’s liabilities off-balance sheet.

In the aftermath of Enron, banks responded to this new guidance cautiously at first. During the early 2000s, there was a lull in off-balance sheet deals. But by 2004-05, banks were using new forms of financial engineering to create VIEs that, like Enron's SPEs, remained off-balance sheet. The FASB was aware of these problems, but decided not to rewrite FIN 46(R). By 2008, VIEs were even more common than SPEs had been a decade earlier.

CONGRESS SHOULD REQUIRE

COMPANIES TO RECORD ALL OF THEIR LIABILITIES

Congress should address the problems associated with the accounting treatment of swaps and VIEs by adopting a general requirement that companies record all of their liabilities in their financial statements. This provision should include all liabilities for which a company will use its assets to pay or liquidate those liabilities. It should include all liabilities that are, in substance, a financing of assets, regardless of legal form. Most crucially, Congress should require that balance sheets include assets and liabilities associated with swaps and VIEs. Without such transparency, regulators and investors who look at the reported assets and liabilities of financial institutions are looking at a mirage. It should not be a radical request to ask that financial statements of banks reflect reality.

Not surprisingly, because Congress has not required that financial statements reflect reality, they do not reflect reality. Off-balance sheet transactions can have legitimate purposes, but too often one of those purposes is to avoid any impact on the balance sheet. As a result, off-balance sheet transactions can swallow up what remains on balance sheet.

Again, consider Citigroup as just one example. In its balance sheet for December 31, 2006, Citigroup recorded \$1.88 trillion of assets and \$1.76 trillion of liabilities, leaving stockholders' equity of \$120 billion. Most of those assets and liabilities were straightforward: assets included loans, trading account assets, federal funds sold and repurchase agreements, and investments; liabilities included deposits, federal funds purchased and repurchase agreements, and short-term and long-term debt. A year later, Citigroup reported some additional items on its balance sheet (it consolidated some of its Structured Investment Vehicles, revalued some swaps, and included various mortgage-related instruments), but the reported value of its equity was down just \$7 billion. By the end of 2008, Citigroup's assets and liabilities on the balance sheet were smaller, but its equity was up to \$142 billion.

Anyone looking only at Citigroup's balance sheet would assume that the bank had experienced a period of relative calm during the financial crisis. Of course, Citigroup's income and cash flow statements revealed a different story, as the bank recorded massive losses from off-balance sheet transactions. Ultimately, the federal government had to execute its own off-balance sheet deal, effectively guaranteeing a portfolio of \$306 billion against losses. Citigroup's losses on off-balance sheet transactions swallowed up the rest of its balance sheet. Citigroup is an illustrative example, and the same analysis holds for other major

financial institutions. Bank officers and directors have argued that the recent financial crisis was a perfect storm, and that no one could have anticipated the downturn in the subprime mortgage markets, or the increase in the correlation of mortgage defaults. But here is the crucial point: the banks, by hiding their off-balance sheet exposures to these markets, including exposures to non-performing subprime loans, did not give investors and analysts a chance. Because bank balance sheets were not transparent, even regulators could only guess at the extent of the banks' exposure to these risks. The hedge funds and other investors who made money speculating on the banks' downfall were not doing so based on analysis of transparent disclosures in the banks' financial statements. That was impossible. Instead, they were speculating on the inaccuracies of those disclosures. When the value of bank stocks depends, not on transparent information the banks have disclosed, but rather on guesses about what the banks have not disclosed, the basic principles of free markets are no longer working, and major reform is necessary.

Many sophisticated analysts and traders understand that bank balance sheets are inaccurate, and they may largely ignore them, instead opting to model their own numbers. However, bank balance sheets are supposed to serve an important function in the financial markets, both for regulators who look to balance sheet measures to assess risk, and for average investors who lack the capacity to parse the "shadow balance sheet" to spot the hints about risks contained in footnoted off-balance sheet disclosures. Balance sheets and shadow balance sheets are at cross purposes. Because the risks of off-balance sheet transactions have grown so large, they have rendered the remaining balance sheet disclosures useless, as was seen in the case of AIG. Congress must act to restore the proper role of the balance sheet in a well-functioning market.

Specifically, Congress should remedy the problems arising from shadow balance sheets by requesting the SEC, or a standard setter designated by it, to require that all liabilities appear on the balance sheet. Then, companies, if they want, can explain the extent of those liabilities in a footnote. Today, the default rule is reversed, with the footnotes – instead of the balance sheet – as the repository of material information.

In other words, Congress should switch the disclosure mandate. It should clarify that financial statements have primacy over footnotes, not the other way around. Regulators and investors should not have to scour hundreds of pages of impenetrable footnote disclosure to get a reliable estimate of liabilities. Instead, banks should determine that number, and report it upfront. If a bank is concerned about the appearance of this number, perhaps because some liabilities are contingent on events they believe are unlikely, they can explain that in a footnote.

An example of language Congress could consider is as follows:

The Securities and Exchange Commission, or a standard setter designated by and under the oversight of the Commission, shall, within one year from the enactment of this bill, enact a standard requiring that all reporting companies record all of their assets and liabilities on their balance sheets. The recorded amount of assets and liabilities shall reflect a company's reasonable assessment of the most likely outcomes given currently available information. Companies shall record all financings of assets for which the company has more than minimal economic risks or rewards.

If the company cannot determine the amount of a particular liability, it may exclude that liability from its balance sheet only if it discloses an explanation of (1) the nature of the liability and purpose for incurring it, (2) the most likely and maximum loss the company could incur from the liability, (3) whether there is any recourse to the company by another party and, if so, under what conditions such recourse can occur, and (4) whether or not the company has any continuing involvement with an asset financed by the liability or any beneficial interest in it. The Commission shall promulgate rules to ensure compliance with this provision, including both enforcement by the Commission and civil liability under the Securities Act of 1933 and the Securities Exchange Act of 1934.

It is crucial that a requirement to disclose all assets and liabilities come in the form of a legislative mandate from Congress. Just as Congress required audits of public companies in the early 1930s, it should require that companies record all assets and liabilities in their financial statements. Guidance from the FASB and interpretation from regulators will be helpful only if they are made pursuant to a broad and clear legislative mandate that companies record all liabilities. As recent experience shows, guidance and interpretation alone – without an umbrella Congressional requirement – will not significantly improve transparency. Disclosures to date from companies, including major financial institutions, indicate that hundreds of billions of dollars of VIEs will escape consolidation. As a result, substantial questions have arisen as to whether the FASB's June 2009 guidance, FASB Statement No. 161, regarding off-balance sheet accounting and securitizations, will result in companies being required to record all of their assets and liabilities. And while this standard is the FASB's most rigorous and robust standard to date, it is also exceedingly complex and will require substantial technical expertise if it is to be implemented properly. (Even the FASB's own Investor Technical Advisory Committee raised numerous concerns with the FASB's proposal.)

The FASB's guidance suffers from two fatal flaws. First, without a clear congressional mandate, the new guidance is subject to the same kinds of interpretations that have encouraged financial engineering and "regulatory arbitrage" transactions designed to move debts off-balance sheet. Specifically, a company is now required to consolidate a VIE only if it has "control" over the VIE's "most signifi-

cant activities” and has the “right to receive benefits or [an] obligation to absorb losses.” By design, this guidance is highly qualitative. It requires judgment and assumptions. Companies can exclude liabilities from their financial statements, as long as they describe their judgments and assumptions in a footnote. That approach is unlikely to generate transparent financial reporting.

Moreover, it remains unclear when banks will be required to adopt the new guidelines for capital purposes. And even among companies that do follow the new approach, significant liabilities will remain off-balance sheet. The savviest regulators understand these limitations, and some have expressed support for a broad off-balance sheet disclosure mandate. As Sheila Bair, head of the FDIC, told the Financial Crisis Inquiry Commission, “Off-balance-sheet assets and conduits, which turned out to be not-so-remote from their parent organizations in the crisis, should be counted and capitalized on the balance sheet.” Congress should follow Ms. Bair’s advice.

Congress should mandate that companies base disclosure decisions on the substance of their VIE transactions. If a company is financing assets, those assets and the related liabilities should remain on the balance sheet, regardless of the form the company uses to construct these financings. If a company continues to manage and service assets, as is commonly the case, or if it continues to receive cash flows from the assets, the assets and liabilities should be reported on the balance sheet. If a company can be required to use its assets to pay for an obligation, that obligation must be reported as a liability on its balance sheet. If a company’s disclosures are based on the most likely outcome given available information, not only will balance sheets be more accurate, but company employees will be more likely to consider the risks associated with transactions. (For example, major financial institutions would have been required to record significant liabilities for subprime related swaps and VIEs.)

Second, even if the new FASB guidance were sufficient, there is no independent enforcement mechanism to ensure that banks accurately report all of their liabilities. Most importantly, although companies generally remain liable for material misstatements, there is no clear and independent provision for civil liability if a corporation omits assets and liabilities from its balance sheet. Indeed, under the current approach, if a company describes the assumptions and judgments supporting its rationale for excluding material liabilities from its financial statements, it can argue that it is not liable for securities fraud, particularly given the complexities of interpreting the existing rules and the widespread custom and practice related to the use of off-balance sheet liabilities. Put another way, companies can argue that, even if they are later found to have violated GAAP by excluding items from their balance sheets, they, and their officers and directors, did not have the requisite mental state required for a finding of securities fraud.

Since the 1930s, the twin pillars of the American market-based system of financial regulation have been (1) mandatory disclosure of material facts, and (2)

enforcement of misstatements and omissions through a robust private right of action. Congress does not need to invent a new legislative rubric to resolve the problems associated with off-balance sheet transactions. Transparency coupled with private enforcement is a tried-and-true strategy. The dual approach of required disclosure and anti-fraud remedies served the financial markets well for more than seven decades. Congress could renew this approach by adopting a standard requiring reporting of all assets and liabilities in financial statements with appropriate disclosures, and by providing for a clear and independent private right of action for failure to comply with such a standard.

Civil liability is a particularly important part of the reform needed in this area. During the previous decade or so, Congress and the courts have whittled away at shareholders' litigation rights by imposing new hurdles related to causation, third-party liability, class action certification, and various pleading and evidentiary requirements. The result is particularly stark in the area of off-balance sheet liabilities. Directors and officers are almost never found personally liable for fraud or breach of duty related to complex financial engineering. Unless mandatory disclosure is paired with effective enforcement, it will be toothless.

Congress should enact the same kind of legislative mandate it pursued during the 1930s. Until recently, the private right of action that arose from America's securities laws had helped to support a transparent and well-functioning market. It is no coincidence that off-balance sheet liabilities and inaccurate financial statements have multiplied as the risk of civil liability has declined. This deterioration also parallels the 1920s, as does its remedy. Oliver Wendell Holmes famously described the law as a prediction of what a judge will do. Yet today any bank officer or director considering whether to approve off-balance sheet accounting rationally would predict that a judge would do nothing. Until recently, few lawsuits have even mentioned off-balance sheet liabilities.

The evisceration of the private right of action is ironic given the growth of the regulatory state and the multiplication of legal rules, particularly in the areas of banking and securities. As the system has become more rules-based, officers and directors understandably have focused more on complying with rules than on achieving the objectives of transparency and accuracy in financial statements. By adopting a rigorous private enforcement regime, Congress could help shift the thinking of officers and directors away from simply complying with rules and instead in the direction of acting in a way they believe a judge would find acceptable at some future date. Moving toward standards enforced *ex post* (and away from rules specified *ex ante*) would help develop a culture of ethics in financial statements. This is particularly important given the failure of regulators to spot and remedy problems at major financial institutions. Without a robust private enforcement regime, a rules-based culture of financial innovation will always be one step ahead of the regulators.

REFORMING OFF-BALANCE SHEET

ACCOUNTING IS A GOOD POLICY WITH BROAD APPEAL

In sum, Congress should mandate that companies report all of their assets and liabilities. Companies that omit material assets and liabilities from their balance sheets should be subject to civil liability in the same way companies generally have been exposed to private rights of action for material misstatements. This is not a radical proposition: it is precisely what Congress did in 1933 and 1934, in response to that era's financial crisis.

At first blush, the off-balance sheet problem might seem unfathomably complicated, and perhaps that is why some people in government did not include reforms directed at this problem as part of the "Plan A" approach to financial reform. But average people understand what liabilities are, and they know what can happen if people are permitted to lie about their debts. Market capitalism requires transparency, or it will not function properly. That is not a controversial proposition. And it is why requiring disclosure of off-balance sheet transactions is a crucial part of "Plan B."

It only takes a few simple questions for the average person to understand how much trouble off-balance sheet accounting can cause. Here are a few: What if the next time you wanted to borrow money you didn't have to list most of your debts? What if Congress let you keep your credit card bills and mortgage liabilities hidden from view? If you could hide your debts, how much would you borrow? What would you do with that borrowed money? How much risk would you take? The answers do not require knowledge of rocket science. Common sense tells us that if we let people hide their debts, they will borrow more than they should, at the wrong times, for the wrong reasons.

Simply put, our biggest banks have been hiding their debts. Even after the recent crisis, they continue to hide them, now more than ever. Most people and business include all of their liabilities on their financial statements. Banks should, too.

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The views expressed in this paper are those of the authors and do not necessarily reflect the positions of the Roosevelt Institute, its officers, or its directors.

OUT OF THE BLACK HOLE

REGULATORY REFORM OF THE OVER-THE-COUNTER DERIVATIVES MARKET

Michael Greenberger

A litany of factors, including lending and financial abuses, led to the subprime meltdown and resulting deep recession. But chief among them was the opaque and unregulated over-the-counter (“OTC”) derivatives (often referred to as “swaps”) market, which was estimated to have a notional value of \$596 trillion at the time of the crisis.¹

THE EXCHANGE TRADING AND CLEARING REQUIREMENTS FOR ALL DERIVATIVES PRIOR TO PASSAGE IN 2000 OF THE HIGHLY DEREGULATORY COMMODITY FUTURES MODERNIZATION ACT

Prior to December 20, 2000, the OTC derivatives market was generally understood to be subject to regulation under the Commodity Exchange Act (“CEA”), because OTC products were a form of futures contracts. Under the CEA, all futures contracts were required to be traded on publicly transparent and fully regulated exchanges. Trading on such exchanges meant that futures contracts were regulated to insure: (1) public and transparent pricing; (2) disclosure of the real trading parties in interest to the federal government; (3) regulation of intermediaries, i.e., brokers and their employers, including stringent rules as to capital adequacy and customer protection; (4) self regulation by exchanges directly supervised by the Commodity Futures Trading Commission (“CFTC”) to detect unlawful trading activity; (5) prohibitions against fraud, market manipulation and excessive speculation; and (6) enforcement of all these requirements by the CFTC and by private individuals and the states through private rights of action and state parens patriae suits.

As an integral part of this regulatory format, futures contracts also had to be cleared, i.e., a well capitalized and regulated intermediary institution was required to stand between the counterparties of a futures contract to ensure that commitments undertaken pursuant to those contracts were adequately capitalized through the collection of margin. Any contractual failure was guaranteed by the clearing facility, a financial commitment that served to insure that the clearing facility had a great incentive to strictly enforce the capital adequacy of traders.

THE COMMODITY FUTURES MODERNIZATION ACT OF 2000 ENDS REGULATORY OVERSIGHT OF OTC DERIVATIVES

On December 20, 2000, the Commodity Futures Modernization Act (“CFMA”) was passed. That legislation was rushed through Congress and enacted by both Houses of Congress on the last day of a lame duck session as a rider to an 11,000 page omnibus appropriation bill.² The 262 page bill was presented to the Senate for the first time on the day that it passed. The CFMA removed OTC derivative transactions, including energy futures transactions, from all require-

ments of exchange trading and clearing under the CEA. Thus, in one fell swoop, the OTC market was exempt from capital adequacy requirements; reporting and disclosure; regulation of intermediaries; self regulation; any bars on fraud, manipulation and excessive speculation; and requirements for clearing. Thus, a market that now has a notional value of many times the world's GDP is a completely private bi-lateral financial market wholly opaque to the world's market regulators, including the U.S. financial safety and soundness overseers.

CREDIT DEFAULT SWAPS AND THE ECONOMIC MELTDOWN IN THE FALL OF 2008

In September 2008, the unregulated OTC market included what was estimated to be \$35-65 trillion in credit default swaps ("CDSs").³ It is now conventional wisdom that the unregulated multi-trillion dollar OTC CDS market fomented a mortgage crisis, then a credit crisis, and finally a "once-in-a-century" systemic financial crisis that, but for trillion dollar U.S. taxpayer interventions, would have in the fall of 2008 completely destroyed the worldwide financial system.⁴

In warning Congress about badly-needed financial regulatory reform efforts when it considered the TARP legislation in Senate hearings before the Senate Banking Committee in September, 2008, then-SEC Chairman Christopher Cox called the CDS market a "regulatory blackhole" in need of "immediate legislative action."⁵ Former SEC Chairman Arthur Levitt and even former Fed Chair Alan Greenspan – both of whom supported the CFMA in 2000 – have acknowledged that the deregulation of the CDS market contributed greatly to the fall 2008 economic downfall.⁶

To understand the central role played by CDSs in the recent meltdown, we must comprehend the subprime securitization process. In brief, the securitization of subprime mortgage loans evolved to include mortgage backed securities ("MBS") within highly complex collateralized debt obligations ("CDOs"). These securitizations were the pulling together and dissection into "tranches" of huge numbers of MBS, theoretically designed to diversify and offer gradations of risk to those who wished to invest in subprime mortgages.

However, investors became unmoored from the essential risk underlying loans to non-credit worthy individuals by the continuous reframing of the form of risk (e.g., from subprime mortgages to MBS to CDOs); the false assurances given by credit rating agencies that were misleadingly high evaluations of the CDOs; and, most importantly, the "insurance" offered on CDOs in the form of CDSs.

The CDS "swap" was the exchange by one counter party of a "premium" for the other counterparty's "guarantee" of the financial viability of a CDO. While CDSs have all the hallmarks of insurance, issuers of CDSs in the insurance industry were urged by swaps dealers not to refer to it as "insurance" out of a fear that CDSs would be subject to insurance regulation by state insurance commissioners, which would have included, inter alia, strict capital adequacy requirements.⁷ By using the term "swaps," CDSs fell into the regulatory "blackhole" afforded by the CFMA's "swaps" exemption (Section 2 (g)) because no federal agency

had direct supervision over, or even knowledge of, the private, bilateral world of “swaps.”

Because a CDS was deemed neither insurance nor an instrument otherwise regulated by the federal government, issuers were not required to set aside adequate capital reserves to stand behind the guarantee of CDOs. The issuers of CDSs were beguiled by the utopian view (supported by ill considered mathematical algorithms) that housing prices would always go up. They believed that even a borrower who could not afford a mortgage at initial closing would soon be able to extract that appreciating value in the residence to refinance and pay mortgage obligations. Under this utopian view, the writing of a CDS was deemed to be “risk free” with a goal of writing as many CDSs as possible to develop what was considered to be the huge cash flow from the CDS “premiums.”

To make matters worse, CDSs were deemed to be so risk-free (and so much in demand) that financial institutions began to write “naked” CDSs, i.e., offering the guarantee to investors who had no risk in any underlying mortgage backed instruments or CDOs. (Under state insurance law, this would be considered insuring someone else’s risk, which is flatly banned.) Naked CDSs provided a method to “short” the mortgage lending market. In other words, it allowed speculators to place the perfectly logical bet for little consideration (i.e., the relatively small premium) that those who could not afford mortgages would not pay them off.

The literature surrounding this subject estimates that three times as many “naked” CDS instruments were extant than CDSs guaranteeing actual risk.⁸ This means that to the extent the guarantor of a CDS (e.g. AIG) had to be rescued by the U.S. taxpayer, the chances were very high that the “bail out” was of a financial institution or hedge fund’s naked CDS bet that mortgages would not be paid. (Of course, holders of those bets formed a strong political constituency against the “rescue” of subprime borrowers through the adjustment of mortgages to keep homeowners from defaulting. If the homeowner stays in the house, the bet is lost!)

Finally, the problem was further aggravated by the development of “synthetic” CDOs. Again, these synthetics were mirror images of “real” CDOs, thereby allowing an investor to play “fantasy” securitization. That is, the purchaser of a synthetic CDO did not “own” any of the underlying mortgage or securitized instruments, but was simply placing a “bet” on the financial value of the CDO that is being mimicked. Synthetic CDOs are also OTC derivatives and therefore not subject to federal regulation. Synthetic CDOs were also “insured” through CDSs.

Because both “naked” CDS and “synthetic” CDOs were nothing more than “bets” on the viability of the subprime market, it was important for this financial market to rely upon the fact that the CFMA expressly preempted state gaming and anti-bucket shop laws.⁹

It is now common knowledge that:

1. Issuers of CDSs did not (and many will not) have adequate capital to pay off guarantees as housing prices plummet, thereby defying the supposed “risk free” nature of issuing huge guarantees for the relatively small premiums that were paid.
2. Because CDSs are private bilateral arrangements for which there is no meaningful “reporting” to federal regulators, the triggering of the obligations there under often came as a “surprise” to both the financial community and government regulators.
3. As the housing market worsened, new CDS obligations were unexpectedly triggered, creating heightened uncertainty about the viability of financial institutions who had, or may have, issued these instruments, thereby leading to the tightening of credit.
4. The issuance of “naked” CDS increases exponentially the obligations of the CDS underwriters in that every time a subprime mortgage defaults there is both the real financial loss and the additional losses derived from failed bets.
5. The securitization structure (i.e., asset backed securities, CDOs and CDSs) is present not only in the subprime mortgage market, but in the prime mortgage market, as well as in commercial real estate, credit card debt, and auto and student loans. As of this writing, the financial media is filled with concerns that forfeitures in the commercial real estate market will worsen substantially, thereby triggering CDSs and naked CDSs for which there will almost certainly be insufficient capital to pay the guarantees. This restarts the downward cycle that drove the country into recession to begin with.¹⁰

THE POTENTIAL FOR SYSTEMIC RISK DERIVES FROM ALL TYPES OF SWAPS

Moreover, while CDSs and synthetic CDOs lit the fuse that led to the recent explosive financial destabilization, the remainder of the OTC market has historically led to other destabilizing events in the economy. These include the recent energy and food commodity bubble (energy and agriculture swaps), the failure of Long Term Capital Management in 1998 (currency and equity swaps), the Bankers Trust scandal and the Orange Country bankruptcy of 1994 (interest rate swaps), and now the sovereign debt crisis in Southern Europe (currency, interest rate and credit default swaps).

PRIOR UNSUCCESSFUL REGULATORY ATTEMPTS

TO OVERSEE THE OTC SWAPS MARKET

Because “swaps” are risk shifting instruments or, in their most useful sense, hedges against financial risk, they were almost certainly subject to the Commodity Exchange Act prior to the passage of the CFMA in 2000. The CFTC in 1993 exempted swaps from the CEA’s exchange trading requirement if none of their material economic terms were standardized and if they were not traded on a computerized exchange.¹¹ This exemption was justified under the regulatory theory that highly customized swaps could not evolve into the kind of “cookie cutter” transactions that cause systemic risk. However, the 1993 exemption did

not satisfy the financial services sector, which wanted to sell almost exclusively standardized swaps that did not require the time-intensive effort that negotiating customized swaps requires. By 1998, the market grew to over \$28 trillion in notional value, with swaps dealers choosing to disregard completely the exchange trading and clearing requirements within the CEA. The overwhelming majority of these instruments derive from a boilerplate, standardized and copyrighted template (the “Master Agreement”) prepared by the International Swaps Derivatives Association (“ISDA”), which represents over 800 financial institutions worldwide.

As a result, in May 1998, the CFTC, under the leadership of then Chairperson Brooksley Born, issued a “concept release” inviting public comment on how that multi-trillion dollar OTC industry might most effectively be regulated pursuant to the CEA on a “prospective” basis.¹² The concept release was premised on 22 economically destabilizing events that had been caused by unregulated OTC instruments up to that time.¹³ The 1998 CFTC concept release spelled out a menu of regulatory tools for the OTC market that have historically been applied to financial markets since the passage of the Securities Act of 1933 and 1934 and the Commodity Exchange Act of 1936 in the early New Deal. These include equities, options and traditional futures contracts, which, if unregulated, would have the financial force to destabilize the economy systemically upon forfeiture of commitments.

The CFTC effort was first blocked by Congress on the recommendation of the remaining members of the President’s Working Group (i.e., the then Secretary of the Treasury, the Chairman of the Federal Reserve and the Chairman of the SEC). Despite the intervening collapse due to OTC trading and rescue of the world’s largest hedge fund at the time (Long Term Capital Management), Congress in 2000 passed the CFMA. This act affirmatively removed OTC derivatives from virtually all federal regulation and oversight.

NEW DEAL NORMS FOR REGULATING SYSTEMICALLY RISKY FINANCIAL MARKETS

As a result of the response to the failure of financial markets in the 1920s, the Roosevelt Administration actively sought and aggressively supervised the passage of the Securities Acts of 1933 and 1934 and the Commodity Exchange Act of 1936. Prior to the 2000 passage of the CFMA, these reforms established the following classic regulatory norms governing the equities and futures markets:

1. *Transparency.* By almost always requiring that systemically risky financial instruments be exchange traded, the public has access to the regular market pricing of these instruments. Moreover, in the case of regulated futures contracts, the CFTC has access to commitment of traders’ reports and large trader reporting so it can determine the real parties in interest involved in large trades. Transparency should also require that all transactions and holdings be clearly accounted for on audited financial statements. The recent meltdown has been characterized by the use of off balance sheet investment vehicles, e.g., structured investment vehicles (“SIVs”), to house and

mask those instruments with potential systemic risk hidden from public view.

2. *Record Keeping.* Traders and intermediaries on regulated markets are required to keep and maintain records of transactions. Not only is there no record keeping requirements in the OTC market, but there is a serious problem of record “creation.” Since August 2005, the New York Fed has complained that financial instruments pertaining to credit derivatives have been poorly documented with back offices being very far behind the execution of credit derivatives by sales personnel.¹⁴
3. *Capital Adequacy.* Intermediaries conducting trades and the traders themselves in regulated markets have capital adequacy requirements to ensure fulfillment of financial commitments.
4. *Disclosure.* Intermediaries and the marketers of financial instruments are traditionally required to provide full and meaningful disclosure about the risks of entering into a regulated transaction.
5. *Anti-fraud and anti-manipulation authority.* The regulated financial markets are governed by statutes that bar fraud and manipulation. The CFMA, however, provides only limited fraud protection for counterparties engaged in securities-based or energy-based OTC derivatives – but affords no such protection for interest rate or currency OTC swaps. The inadequacy of even the security-based protection is evidenced by both former SEC Chairmen Cox and Levitt calling regulation of these markets a “regulatory blackhole.”¹⁵ Fraud protection without transparency of transactions to the federal regulator is meaningless.
6. *Regulation of Intermediaries.* “Brokers” of equity and regulated futures transactions are subject to registration, competency examinations and adherence to prudential conduct. Not only is there no such protection within the swaps market, but pursuant to the ISDA Master Agreement, which governs most swaps transactions, the non-bank counterparty undertakes that it is not relying on representations of the marketer of swaps and otherwise must certify that the transaction is in accordance with U.S. law and the law of all of the states. This amounts to caveat emptor on steroids.
7. *Private Enforcement.* As is true in securities laws and laws applying to the regulated futures, private parties in the swaps markets should have access to courts to enforce anti-fraud and anti-manipulation requirements and to challenge all other unlawful activities, thereby not leaving enforcement entirely in the hands of overworked (and sometimes unsympathetic) federal enforcement agencies. Similarly, under the CEA, appropriate state officials may bring such actions on behalf of citizens of the state adversely affected by illegal futures transactions, i.e., *parens patriae* actions. Because the OTC derivatives market operates outside of almost all regulatory obligations, private rights of action and *parens patriae* actions are essentially undercut because there are no “rights” to enforce.
8. *Mandatory Self Regulation.* As is true of the securities and traditional futures trades conducted on regulated exchanges, swaps dealers should be required to establish a self regulatory framework overseen by a federal regulator, including market surveillance, to ensure the safety and soundness of the trading system and to be the first line of defense against fraud

and manipulation by dealers in the swaps market.

9. **Clearing.** Again, as is true of the regulated securities and regulated futures infrastructure, a well capitalized and federally supervised intermediary should clear all trades as a protection against a lack of creditworthiness of, and default by, OTC derivatives counterparties.

The adoption of the traditional regulatory market protections for swaps would essentially return these markets to where they were as a matter of law prior to the passage of the CFMA in December 2000. The general template would be that swaps would have to be traded on a regulated exchange (which provides each of the protections outlined above). They would also have to be cleared by a well capitalized and regulated clearing facility unless the proponents of a risk shifting instrument demonstrate to the appropriate federal regulator that the instrument both on its own and as universally traded cannot cause systemic risk and will not lead to fraudulent or manipulative practices if traded outside an exchange and clearing environment. That is why the CFTC, in 1993, using exemptive authority provided to it by Congress, excused from exchange trading and clearing requirements swaps contracts not traded in standardized format, i.e., which are negotiated as to each of the instrument's material economic terms on a contract-by-contract basis.

Two further points should be emphasized:

Simple Clearing Is Not Enough. The financial services industry has argued vociferously that the requirement of clearing for OTC derivatives is all the regulation that is needed for these markets and that exchange trading should not be required. However, providing clearing only addresses one of the traditional regulatory protections outlined above: i.e., assuring the capital adequacy of counterparties (assuming that clearing facilities themselves will be properly regulated to ensure their own adequate capitalization). Capital adequacy is only one of the key requirements of traditional market regulation. With clearing alone, you do not have: (1) transparency as to pricing and the real parties in interest; (2) regulation of intermediaries for competency and prudential conduct; (3) self regulation to assist federal regulators in oversight; (4) record keeping and full documentation; (5) prohibitions on fraud and manipulation; (6) full disclosure to counterparties and to the federal government; (7) and meaningful private enforcement. Equities and traditional futures trading have this complete regulatory infrastructure built around the clearing process. And we would never settle for clearing, and clearing alone, as a substitute for the full regulatory and self regulatory structure that surrounds, for example, the equities market. Yet, the dollar volume of OTC derivatives is far in excess of the equity markets and unregulated OTC instruments have repeatedly occasioned the threat and presence of systemic risk.

Clearing facilities themselves must be rigorously regulated. The CFTC's present regulatory scheme to approve clearing facilities requires the facility to meet highly generalized goals. It also allows the facility to begin operating upon filing

of its application, rather than pre-approval by the CFTC. Moreover, the approval process is delegated to the CFTC staff rather than the Commission itself.

The mere existence of a clearing facility is not an automatic panacea to systemic risk. Five years ago, AIG might have convincingly advanced itself as financially sound enough to be a clearing institution. Similarly, an AAA entity that appears sound today may become unstable if the entire derivatives market is not adequately policed. In sum, the limited step of clearing by itself does not adequately protect against systemic risk. Given the great importance of approving a financially strong institution to clear these highly volatile and potentially toxic products, pre-approval of a clearing facility should be always required. It should also be required that the appropriate federal regulatory entity –not just the staff of that entity –issue affirmative and detailed findings about its confidence in the applicant serving as an OTC clearing facility. As Patrick Parkinson (then Deputy Director, Division of Research and Statistics of the Federal Reserve System) made clear in his November 20, 2008 testimony before Congress, the President's Working Group on Financial Markets is advising that OTC clearing facilities' qualifications be measured against the comprehensive "Recommendations for Central Counterparties" of the Committee on Payment and Settlement Systems of which Mr. Parkinson was the Co- Chair and on which the CFTC and SEC served.¹⁶ Those comprehensive standards for clearing facilities should be included in any comprehensive regulatory reform legislation and federal overseers should issue detailed findings that the clearing facility meets those standards before clearing on that facility begins.

PENDING DERIVATIVES LEGISLATION AND LEGISLATIVE PROPOSALS

THE OBAMA ADMINISTRATION WHITE PAPER

In response to the catastrophic systemic failure caused by unregulated derivatives, the Obama Administration in its June 2009 White Paper proposed that all standardized OTC derivatives be subject to clearing and exchange trading. It proposed that they be overseen in accordance with the traditional dictates of market regulation that had been in place since the New Deal and that were abandoned only in the deregulation of OTC derivative markets in 2000. The Administration also recommended that "[a]ll OTC derivatives dealers and all other firms whose activities in those markets create large exposures to counterparties should be subject to a robust and appropriate regime of prudential supervision and regulation,"¹⁷ including the imposition of increased capital requirements, business conduct standards, and auditing requirements.¹⁸

The Administration further proposed that so-called "customized" derivatives may remain traded as over-the-counter products. The Administration acknowledged the potential for exploitation that differentiated derivative regulation entails, and sought to close any perceived "customization" loophole through greater oversight over dealers in customized products. Treasury Secretary Geithner had said that criteria he would employ to distinguish customized from standardized derivatives would be, by design, "difficult to evade."¹⁹ CFTC

Chairman Gary Gensler also articulated a series of tests that would delineate standardized from customized instruments in a manner that would create a strong presumption that most of the existing OTC market would be deemed standardized and thus subject to exchange trading.²⁰

In July 2009, a Blue Ribbon “Independent Task Force” composed of distinguished experts, i.e., the Investors’ Working Group co-chaired by former SEC Chairmen Arthur Levitt, Jr. and William H. Donaldson, reached many of the same conclusions as are found in the Obama Administration White Paper on regulating OTC derivatives.²¹

THE TREASURY’S OTC DERIVATIVES LEGISLATIVE PROPOSAL

However, on August 11, 2009, the Treasury Department, on behalf of the Administration, submitted to Congress a specific legislative proposal (the “Proposed OTC Act”) in furtherance of its prior narrative recommendations. The Proposed OTC Act created new and significant loopholes that would undermine the Obama Administration’s stated goals for OTC derivative reform, namely, that the new regulatory structure “would cover the entire marketplace without exception.”²²

On August 17, 2009, CFTC Chairman Gary Gensler, in a letter to Congress, critiqued the following exclusions suggested by Secretary Geithner, but not previously found in the Obama Administration’s narrative OTC reform proposals.

1. Foreign Exchange Swaps Exclusion. Chairman Gensler correctly explained: “The Proposed OTC Act would exclude foreign exchange swaps and foreign exchange forwards from the definition of a ‘swap’ regulated by the CFTC. The concern is that these broad exclusions could enable swap dealers and participants to structure swap transactions to come within these foreign exchange exclusions and thereby avoid regulation. . . . In short, these exceptions could swallow up the regulation that the Proposed OTC Act otherwise provides for currency and interest rate swaps.”²³

Chairmen Frank and Peterson, leaders of the two committees of jurisdiction on this legislation in the House of Representatives, challenged the wisdom of this exclusion, claiming that it would eliminate from the exchange trading and clearing requirements over \$50 trillion in swaps.²⁴

This kind of exclusion has proven highly problematical. Recently, we have discovered that Greece and Portugal, and possibly Italy and Japan (if not many others), have used, inter alia, foreign currency swaps sold by U.S. swaps dealers as a vehicle for masking short term sovereign debt in order to, inter alia, gain entrance to the European Union in exchange of the case of Greece for paying swaps dealers hundreds of billions of dollars in Greek revenue streams extending to the year 2019.²⁵ As one leading derivatives expert has noted, in these kinds of transactions, “the participant receives a payment today that is repaid by the higher-than-market payments in the future. . . . Such arrangements provide

funding for the sovereign borrower at significantly higher cost than traditional debt. The true cost to the borrower and profit to the [swaps dealer] is also not known, because of the absence of any requirement for detailed disclosure.”²⁶

2. Exceptions from Mandatory Clearing and Exchange Trading for Non-Banks.

The Treasury’s Proposed OTC Act included a further major and crippling loophole. As explained by Chairman Gensler, the Proposed OTC Act “creates an exception . . . from the mandatory clearing and trading requirements [if] one of the counterparties is not a swap dealer or major swap participant [(a non bank swap participant that does not present systemic financial risks.)) This excludes a major significant class of end users from the clearing and mandatory trading requirement.”²⁷

Thus, by its clear language, the general regulatory protections in the Treasury’s Proposed OTC Act apply only to transactions between swaps dealers or between swaps dealers and other large institutions. As Chairman Gensler so correctly stated: “This major exception may undermine the policy objective[s] of lowering risk through bringing all standardized derivatives into centralized clearing . . . and increasing transparency and market efficiency though bringing standardized OTC derivatives onto exchanges”²⁸

Of course, the end user exemption theoretically was dealt with in the Obama White Paper by recognizing that truly customized agreements with end users would not be subject to exchange trading and clearing. By nevertheless including an end user exemption without reference to customization, the Treasury bill completely ended the standardization/customization dichotomy by acknowledging that even standardized end user agreements (which could be exchange traded and cleared) would now not be regulated. In this regard, the Treasury proposal is more deregulatory than the 2000 CFMA, which requires that in order to be deregulated, a swap must be “*subject to individual negotiation*.”²⁹ Eliminating the “subject to negotiation” requirement in the CFMA of 2000 resolved pending litigation in favor of the swaps dealers and ISDA, whose practice of claiming that its mandatory standard, boilerplate and copyrighted Master Agreement for swaps was “subject to individual negotiation” had been challenged in court.³⁰

3. Thwarting State and Private Regulatory Enforcement. The August 11, 2009 Treasury legislative proposal also recommended – without explanation – maintaining the 2000 CFMA’s preemption of state gaming and anti-bucket shop regulation for unregulated OTC derivative products. As shown above, these OTC products are often marketed and used – not as hedging devices – but for pure speculation on future events. Since these instruments are unregulated on the federal level, states could (and should) readily view, for example, the purchase of a naked CDS guarantee on a CDO (which is in this case not owned by the “insured”) as gambling on the non-payment of mortgages by subprime borrowers in violation of state gambling laws. Similarly, many swaps dealers market “bets” on the upward movement of physical commodities, such as energy

and food products, where the counterparty gains if the products rise in price, but loses if the price goes down.³¹ These commodity index swaps have been widely criticized as causing the huge upward price movement in physical commodities in defiance of market fundamentals. For example, Professor Nouriel Roubini describes the 2009 commodity spike as “money chasing commodities” and states that “[t]here is a risk that oil can rise to \$80, \$90 or \$100 because of speculative demand,”³² thereby likely breaking the back of any economic recovery from the debilitating recession caused by the subprime meltdown. Indeed, on March 24, 2009, 184 U.S. based and international human rights and hunger relief organizations sent a letter to President Obama urging the “re-regulat[ion of] the food and energy [swaps] to remove excessive speculation that has so clearly increased price volatility in the last few years.”³³ Again, the preemption provisions within the 2000 CFMA and supported by the Treasury tie the states’ hands at combating price distortions caused by betting on physical commodity prices.

In addition, the Treasury’s proposed August 11, 2009 language clarifies an ambiguity in the 2000 CFMA, making it clear that neither a private party nor a state can seek to void an illegal swap in either state or federal court. Under this provision, if a swap does not satisfy the requirements of the federal law under which the swap is governed, it nevertheless cannot be invalidated nor can damages be awarded on that swap. This “anti-voiding” provision advocated by Treasury creates a perverse incentive for a swap dealer to completely ignore the laws that otherwise govern the swap. Moreover, the Treasury anti-voiding language once again resolved an ambiguity in the CFMA in favor of ISDA and the swaps dealers, which is now at the heart of ongoing litigation.³⁴

H.R. 4173, TITLE III (THE HOUSE DERIVATIVES BILL)

On December 11, 2009, the House passed by a vote of 223-202 H.R. 4173 in which Title III addressed the regulation of derivatives. While this bill is quite long and intricate, in general contours it follows the August 11, 2009 Treasury legislative proposals insofar as it: (1) includes the foreign exchange swap and non-bank end users’ exemptions – although upon joint agreement of the Treasury (which strongly supported the exemption) and the CFTC, the statutory foreign exchange swap exemption can be ended; (2) continues to preempt state gaming and anti-bucket shop laws for swaps that are not cleared and exchange traded; (3) ends the dichotomy between standardized and customized swaps, thereby ending the CFMA’s requirement that swaps exempt from exchange trading must be “subject to individual negotiations” and allowing standardized swaps for the first time to evade exchange trading requirements; and (4) continues to provide that swaps not complying with the statute can, nevertheless, not be voided if counterparties meet minimal net worth requirements.

Three further deregulatory measures crept into the House bill:

1. Swaps Execution Facility. First, while the bill continues to require that swaps not otherwise exempt must be exchange traded, at the behest of Wall Street

lobbyists, the exchange trading requirement can be satisfied by placement of a privately executed swap on a “swaps execution facility,” which includes electronic trade execution or voice brokerage. While the electronic trade must be conducted by an entity “not controlled” by the counterparties, if the “SEF will not list the contract, it does not have to be executed.”²⁵ In other words, the swap does not need to be exchange traded if it is submitted to a swaps execution facility that will not trade the swap. Pursuant to vigorous Wall Street lobbying, this SEF (introduced in House Agriculture Committee mark up) appears to undercut completely the bill’s and the Obama Administration’s exchange trading requirement.³⁶ The provision for the SEF must be removed from any bill addressing the regulation of derivatives and swaps.

2. Abusive Swaps. In Chairman Frank’s discussion draft presented to the House Financial Services Committee markup, the legislation would have authorized the SEC and the CFTC to ban abusive swaps and then to jointly report such abuses to Congress.³⁷ As reported out of the House Financial Services Committee Markup and as passed by the full House, the provision simply provided that the CFTC and SEC could jointly report abusive swaps to Congress³⁸ – and deleted the authority to ban those swaps.

This substantial weakening of the “abusive swap” provision is quite significant. Even if the CFTC and SEC have the authority to enjoin swaps that are fraudulent and manipulative, the question may still arise whether those agencies can stop otherwise legitimate swaps that may not be fraudulent or manipulative but are destructive, nevertheless, to financial stability. The discussion above about CDSs and naked CDSs illustrates that those counterparties holding a CDS guarantee of a huge payout upon default of an instrument or an institution have an economic incentive to encourage the default. The classic case mentioned above is the holders of naked CDS guarantees who have bet that subprime mortgages will default have been accused of successfully lobbying against any legislation that would allow alteration of mortgage obligations to allow homeowners to stay in their homes. That conduct may not be fraudulent or manipulative. But it is highly abusive and federal regulators should have authority to ban that kind of destructive financial conduct – not simply “report” it to Congress.

Indeed, shortly after the House passed H.R. 4173, a further incident occurred that clearly demonstrated the need for federal regulators to ban abusive swaps. In order to avoid bankruptcy and the loss of 30,000 jobs, YRC Worldwide, Inc. (“YRC”) attempted to have certain of its bondholders convert their debt status to equity in order to clean up the YRC balance sheet. YRC is the largest U.S. manufacturer of trucks. Shortly before the deadline for conversion on December 23, 2009, the Teamsters Union, representing the YRC workers, discovered that certain Wall Street interests were marketing a strategy to defeat this rescue effort. Those interests were marketing a financial package that included the sale of the bonds in question along with CDSs that would pay off upon the bankruptcy of YRC. To profit from the package, the investor holding the bond would vote against the bond/equity exchange, triggering the bankruptcy with an

accompanying huge payout on the YRC CDS.

On December 22, 2009, Teamster President James Hoffa sent a letter to state regulators calling for an investigation of this highly damaging financial package and held a press conference denouncing the attempt to profit from the destruction of the fragile U.S. manufacturing base and 30,000 union jobs just as the U.S. was trying to fight its way out of the recession. The deadline for the bond conversion was extended to December 31, 2009. Upon being confronted by the strong Teamster reaction, several of the Wall Street marketers of this financial transaction switched their position (i.e., voted for the bond conversion) and the company was saved shortly before the New Year.³⁹ Several states are considering or have begun an investigation of this financial ruse.

Had the original House language authorizing the CFTC or SEC to ban abusive swaps been enacted into law, the YRC episode would have been a poster child for prompt federal action. As George Soros has recently said pertaining to the moral hazard associated with CDSs, “the market in credit default swaps . . . is biased in favor of those who speculate on failure. Being long on CDS, the risk automatically declines if they are wrong. This is the opposite of selling short stocks, where being wrong the risk automatically increases.”⁴⁰

3. Further Preemption of State Investor Protection Laws. It is ironic that the states, rather than the federal government, were willing to intervene to help the Teamsters Union defeat Wall Street’s attempt to use, *inter alia*, CDSs to drive the nation’s largest truck manufacturer into bankruptcy two days before Christmas. However, in addition to eliminating the CFTC’s and the SEC’s ability to ban abusive swaps, the House bill preempted state insurance laws as they apply to swaps.⁴¹ (Again, the House and the Treasury also supported continuing the preemption of state gaming and anti-bucket shop laws as applied to swaps not traded on exchanges.) As mentioned above, CDSs have all the characteristics of insurance policies. The states have begun to aggressively pursue a model state insurance law that would require CDS, *inter alia*, to be capitalized adequately and to ban “naked” CDS as illegal insurance that insures the risks of other parties. With almost no explanation, shortly before the H.R. 4173 went to the floor, Chairmen Frank and Peterson introduced the insurance preemption into the bill over the express objection of state insurance officials, including the National Council of Insurance Legislators, which is drafting the model legislation.⁴²

Not only should the preemption of state insurance laws be removed from the derivatives reform legislation, but the preemption of state gaming and anti-bucket shop laws for swaps that are not exchange traded must be ended as well. Senator Maria Cantwell has introduced legislation ending the gaming and bucket shops preemption.⁴³

SENATE DERIVATIVES LEGISLATION

As of this writing, neither of the two Senate committees of jurisdiction (Banking and Agriculture) has introduced legislation concerning the regulation of OTC

derivatives. On November 10, 2009, Senate Banking Chairman Dodd introduced a discussion draft of a financial regulatory reform bill that for the most part followed the template of the U.S. Treasury legislative proposal on derivatives but greatly restricted the exemption from exchange trading for those derivatives needed by end users to hedge commercial risk.⁴⁴ After a hostile Republican reaction to the Dodd bill, the Chairman attempted to develop a bipartisan compromise. In recent days, it has been announced that a Senate Banking bill will emerge shortly – although it is unclear whether it will be fully bipartisan in nature.⁴⁵ If it is a bipartisan bill, the derivatives portion is expected to be much more deregulatory than the House bill or the original Dodd proposal, especially by expressly eliminating any requirement that a swap not subject to the foreign exchange or end user exemption will only have to be cleared and it will not have to be exchange traded. As of this writing, the Senate Agriculture Committee has not yet indicated the legislative direction it will take on this issue.

CONCLUSION

Unregulated OTC derivatives have been at the heart of systemic or near systemic collapses – from the 1995 bankruptcy of Orange County; to the collapse of Long Term Capital Management in 1998; to the bankruptcy of Enron in 2001-2002; to the subprime meltdown and resulting severe recession in 2008, and now to the emerging sovereign debt crisis in Europe. After each crisis, governments worldwide proclaim that the OTC market has to be regulated for transparency, capital adequacy, regulation of intermediaries, self regulation, and strong enforcement of fraud and manipulation. But, aided by the passage of time, Wall Street always deflates those aspirations with aggressive lobbying. The present financial reform regulatory effort may be the only chance to get this issue right before the country devolves into a further financial quagmire with more bankruptcies and more job losses. A review of the House's effort in this regard and present Senate proposals is not encouraging.

To avoid further systemic (and possibly irreparable) meltdowns, legislation must be enacted that:

1. Requires all standardized derivatives to be cleared by well-capitalized clearing facilities (to ensure capital adequacy and regularized marking to market of swaps). Legislation must require standardized derivatives to be traded on fully transparent and well regulated exchanges (to ensure price and trader transparency, regulation of intermediaries, self regulation, full disclosure and reporting (including having all derivatives "on balance sheet"). There must be strict anti-fraud and anti-manipulation requirements enforced by the federal government and the states, as well as private parties injured from such malpractices.
2. All swap dealers should meet strict capital and record keeping requirement, as well as business conduct rules.
3. Abusive swaps that are designed or marketed to cause economic injury and instability, e.g., forcing bankruptcies and unemployment, should be banned upon appropriate findings by the federal government.
4. There should be no federal preemption of state causes of action that

protect consumers and investors from derivatives transactions that are not cleared or exchange traded, including state insurance, fraud, gaming, and anti-bucket shop laws.

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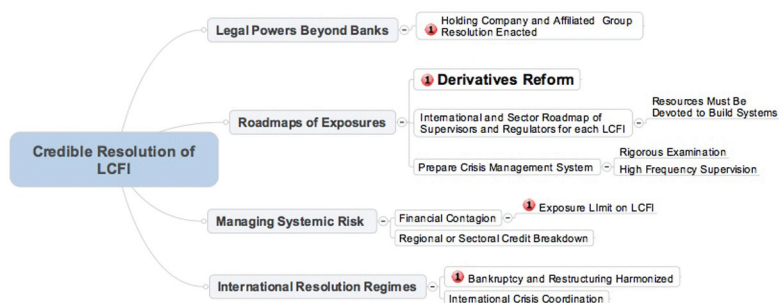
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CREDIBLE RESOLUTION

WHAT IT TAKES TO END TOO BIG TO FAIL

Robert Johnson



The market system depends upon the discipline of failure.

This is the basis of dynamic evolution of the economy and is essential to the legitimacy of the market system. When failure occurs, corporate finance has well-developed principles and procedures for bankruptcy and the restructuring of failing firms. We have all seen these procedures in action in the failure of airlines, auto companies, the bankruptcy of nonfinancial businesses both small and large, like Kmart, Texaco, and Converse, Inc. We have seen them in the failure of venture capital start-ups, and even with smaller financial institutions. Well-known individuals – from P.T. Barnum to Walt Disney to Donald Trump – have gone through bankruptcy.

But the discipline of bankruptcy and restructuring has not been applied to the large complex financial institutions (LCFIs) in the recent financial crisis. The inability to apply market discipline to LCFIs is not only unsound; it has forced the citizens of the United States to support them with a great deal of money via bailouts and guarantees.¹ When LCFIs are not penalized for failure, it sets a terrible precedent for their future behavior— creating an unhealthy dynamic in which bailouts are assumed and risky behavior is underwritten. Worse still, when society perceives a distance between how individuals and businesses are disciplined, anger and demoralization flourish. The resulting distrust in government makes it even more difficult to fix a broken regulatory system.

The defenders of the treatment of LCFIs appeal to the notion of systemic risk, which is an unclear concept, but suggestive of spillovers from the failure of LCFIs to other parts of the economy. Top management of the LCFIs argues vociferously against regulation of their activities. At the same time, they invoke and amplify the fear of systemic spillovers when appealing to the authorities for bailouts in the throes of a crisis.² Under the current broken system of regulation of LCFIs, there are no doubt many potential spillovers that could cause harm to the wider economy. Yet many of these spillovers or externalities are either unnecessary or unnecessarily large.

The goal of this chapter is to make recommendations to eliminate the distance between how insolvent LCFIs are treated and how individuals and other businesses are treated when on the cusp of failure, after carefully examining the context in which the resolution authorities cope with a failing LCFI.

The method to achieve the goal is to examine the impediments that stand in the way of the practice of sound corporate finance principles that apply to failure and restructuring of an LCFI, and to recommend structural and legal changes that will remove those impediments.

THE CHALLENGE FACING THE RESOLUTION AUTHORITIES

The resolution authorities have to consider a number of dimensions of cost when resolving an insolvent financial institution in order to impose the least cost on society. There are several dimensions to consider when looking at that cost:

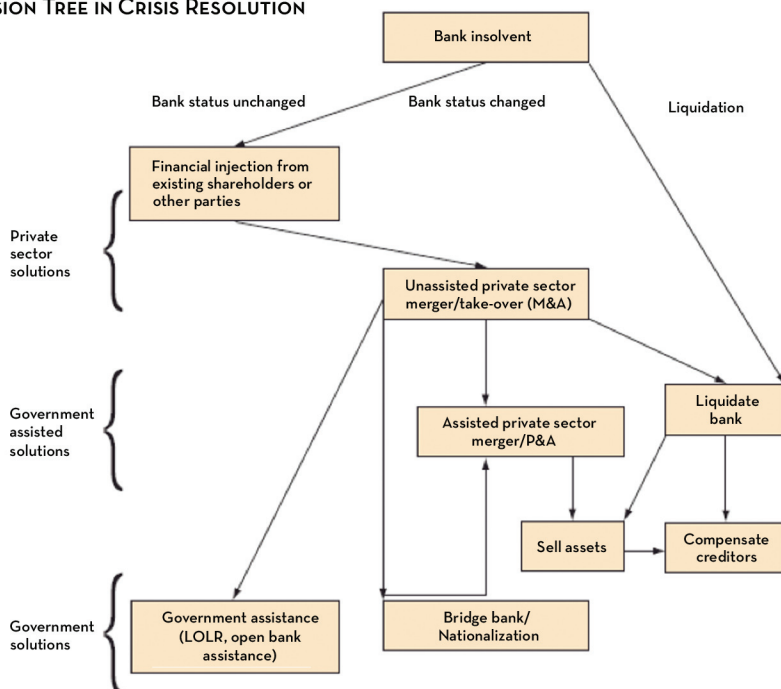
1. The budgetary cost of the bailout/restructuring. (Fiscal Bailout Costs)
2. The costs in lost output and employment associated with any spillovers from the failing financial firm to the real economy. These include:
 - a. Costs that spill over onto sectors or regions of the economy whose credit allocation depend upon the specific LCFI that is failing. (Direct Spillovers)
 - b. Financial contagion, those costs created by spillovers to other financial firms with exposures to the firm being restructured. These firms, in turn, harm the real economy through the weakening of the credit allocation process. (Financial Spillovers)
3. The costs of the precedent this resolution example sets when it becomes imbedded into LCFI management expectations about the incentives they will face in the future. (Moral Hazard)
4. Costs associated with how the burden of the bailout/restructuring influences the public's trust in government. (Reputation of Government)

The resolution authorities are entrusted by the public to consider all of the tools of resolution to minimize the cost to society when an LCFI fails. (See Diagram 1) When this is done well – when burdens are shared fairly and in a way that is mindful of all of these costs – the government's reputation is not tarnished.³

The principles of proper resolution of a failed corporation are nothing new.⁴ They include:

1. Conservation of the value of the assets, including the going concern value if that is possible, of the firm.
2. Dilution or wipe out of common equity.
3. Restructuring of creditors, in accordance with priority to convert some portions of debt into equity.
4. Submission of letters of resignation by top management of the failing firm that can be accepted or rejected by the owners of the new organization.

**DIAGRAM 1:
DECISION TREE IN CRISIS RESOLUTION**



For most businesses, including smaller financial firms and nonfinancial corporations – even those that garner public assistance – this has largely been the process and the practice. Businesses like airlines, along with hundreds of small banks, are handled according to the tried and true criteria.

The LCFIs clearly were not handled in the traditional manner, revealing U.S. government reluctance to apply the known principles of proper resolution, including the wiping out or dilution of common equity or the firing of the LCFI top management that failed in their responsibilities and imposed upon the taxpayers.

What costs deterred the resolution authorities from restructuring the LCFIs in the same way that any other corporate failure is handled? What impediments to credible resolution can be removed so that both policymakers and officials treat a LCFI in the same manner as any other failing corporation? If these obstacles cannot be removed, then society must either 1) regulate LCFIs much more aggressively or; 2) Break them up so that the authorities no longer fear restructuring them.

Credible resolution of LCFIs is necessary to restore the legitimacy of the market system of discipline in the United States and around the world.

OBSTACLES TO RESOLUTION OF LCFI

Creating a credible resolution regime requires removing the impediments to resolution of an insolvent LCFI when it is on the doorstep of failure. In what follows, we will address the key impediments that push policy makers to engage in forbearance⁵ when they should be restructuring the LCFI. The primary obstacles are:

1. Fear of amplifying systemic risk, most focally financial contagion, because an LCFI is deeply intertwined with other LCFIs and likely to come into the hands of the resolution authority on the verge of failure precisely when other financial institutions are also extremely fragile.
2. Legal impediments under current U.S. law that must be changed to enable the resolution of financial services holding companies, including bank holding companies – not just the banks that are subject to the provisions of “prompt corrective action” enacted to facilitate resolution of a failed firm by the FDIC.
3. The resolution authorities’ lack of a roadmap of the LCFIs’ exposures and an understanding of the transmission of losses that their resolution would ignite. The pervasiveness of often-complex and sometimes-unregulated derivative instruments leaves the resolution authority paralyzed with the dread of igniting unintended and unforeseeable consequences. Authorities are steering a ship through treacherous waters around many icebergs – without proper charts, sonar and navigational equipment.
4. The global ramifications of the resolution. The resolution authorities must understand the consequences of their actions. The propagation of losses outward from the failing LCFI to foreign LCFI and other commercial interests must be understood before resolution authorities take action. Understanding these consequences is vital, and requires foreign governments to be enlisted to cooperate in the proper supervision and monitoring of a global firm. Most, if not all, LCFIs operate in many countries, in many legal and regulatory jurisdictions, and with branches or subsidiaries operating under a myriad of supervisory regimes. In fact, some elements of the matrix of operations exist with no regulation or supervision. This prevents authorities from understanding clearly the impact and consequences of an LCFI’s resolution across the entire planet. Another major international obstacle is the difficulty of restructuring the liabilities of a failing LCFI according to sound principles of corporate finance and of apportioning a balanced share of the burden of loss across all creditors when operating across a myriad of separate legal jurisdictions.

In what follows, each of these impediments to credible resolution is discussed, along with available means to remove the obstacles that induce the authorities to adopt a strategy of forbearance for an insolvent LCFI.

FINANCIAL CONTAGION AN OBSTACLE TO CREDIBLE RESOLUTION.

Many proposals for financial resolution set out principles and action guidelines

that are based on the vision of resolving one isolated troubled institution. Yet in practice, when an LCFI is in danger of insolvency, many other financial institutions will also likely be fragile and on the threshold of insolvency. The difficulties are compounded when the cross-exposures between these institutions are substantial. Undeniably there were marked differences in the quality of management across the large firms, but if the question “Are you solvent?” were posed to a chief financial officer at many, if not all of the 9 largest U.S. firms in 2008, the officer would have been forced to reply with a contingent statement like, “It depends upon how the other 8 are resolved and what action the government takes.” When one considers the challenge of 2008 and early 2009 in the U.S., it is very clear, from pre-Bear Stearns failure to the decisions to forbear when Citigroup and Bank of America’ equity capitalization were dwindling, that the context to evaluate resolution was one where a constellation of LCFIs were all in jeopardy together.

When firms are so intricately intertwined, resolution authorities are tempted to avoid action. They are likely to fear that a proper restructuring of any one LCFI’s liabilities may just transmit the losses to other LCFI and take other financial institutions into insolvency. Firm A’s losses, once realized, lead to a write-down of its exposures on the balance sheet of Firm B. If they have large cross-exposures, that may make Firm B insolvent, too.

We need large preemptive action rather than fear and inaction. A resolution process that resembles a bank holiday and comprehensive examination, where the insolvency of some or all firms and the cross-consequences of restructuring shared exposures, would lead to a broad based recapitalization of the LCFI firms in parallel. In the 1930s, under Franklin Roosevelt, similar procedures were undertaken by the Reconstruction Finance Corporation. Such comprehensive recapitalization is intended to fortify the financial system as a whole, with capital injections from the public sector and apportioning of the dilution of equity shares across the constituent firms.

There are formidable obstacles to a prompt resolution of this nature, even though it would distribute losses appropriately and mitigate gross unfairness. First, current information requirements are beyond what are available on a timely basis to examine and supervise each of the LCFI. The scenario planning and knowledge of cross-exposures between LCFIs must be known and up to date before the onset of a crisis. We need a formidable, well-compensated infrastructure in order to conduct ongoing real time examination. Such a process, prepared well in advance, is necessary to give the authorities the confidence to act decisively and rapidly.

A second obstacle to a prompt parallel resolution⁶ is political: the different LCFIs have varying degrees of confidence in their ability persuade and manipulate government. Because of these differences, one could predict that the bailouts would be sequential rather than undertaken in parallel, and that the politically weaker firms would bear the brunt of the loss of equity and manage-

ment compensation. The politically stronger firms go hide in a closet and wait for the weaker firms to be resolved and fortified, all the while working to make sure that the restructuring was done in a manner that did not damage their net worth if they had significant cross-exposures. Once the resolution authorities had moved through the weaker firms and fortified them with taxpayer funds, the CFOs at the politically stronger firms could emerge from hiding and give an honest “Yes” to the question of whether their firms were solvent.

Society should not tolerate the costs of resolution authorities working in this sequential manner, in deference to the politically stronger LCFIs. The likely costs are significant:

1. A sequential intra-financial sector political struggle may deepen the crisis as the financial system freezes up for prolonged periods when the fear of counterparty default risk is widespread. The costs to output, employment, and the eventual cost of bailout are likely to be significantly larger than would result from a prompt parallel corrective resolution.
2. A sequential process is likely to deter the authorities from writing down the elements of the liabilities of the failing firms for fear of transmitting greater fragility to the remaining unresolved systemically significant financial institutions.
3. This reluctance to amplify systemic contagion is understandable. But it implies that the resulting taxpayer burden in resolution is likely to be greater, and the politically strong firms, their creditors, stockholders and managements made better off, through undeserved subsidies that powerfully diminish public trust in the financial authorities.

Fear of financial contagion on the part of authorities, coupled with the political power games that the LCFIs play to influence the management of crisis episodes, inhibit timely, credible and cost-effective resolution of failing financial institutions. Three recommendations for reform to address this challenge are:

1. Significant limits on the cross exposures that can be maintained on balance sheets between systemically significant institutions must be specified so that the constellation of LCFI cannot wrap themselves in the blanket of each other and deter resolution on the grounds of financial contagion.
2. Substantial investment in information systems and quality, well paid, personnel for high level supervision is needed to invigorate the examination of LCFI and to diminish uncertainty about the “roadmap” of exposures between financial firms. Indeed, a timely roadmap of all exposures of each LCFI is important to understanding the impact of resolution on the economy and the world.⁷
3. LCFIs should be severely limited in the lobbying and campaign contributions that they can make to the Presidential candidates and Congress. We need a rule that prohibits those sitting on financial committees, Senate Banking, House Financial Services, Senate Agriculture and House Agriculture, from receiving contributions from LCFIs. In

addition, House and Senate Leadership should also be subject to the same prohibition.⁸

COMPLEX, OPAQUE AND MARK-TO-MODEL DERIVATIVES AS AN OBSTACLE TO CREDIBLE RESOLUTION⁹

The recent crisis in the U.S. centered on the collapse of the housing bubble and the role of leverage, off balance sheet exposures, and complex OTC derivatives. Chapter (8) on off balance sheet reform and Chapter (9) on derivatives market reform address the structural remedies that are required to restore integrity and transparency to these dimensions of our financial system that directly involve LCFI. For credible resolution, I believe that proper derivatives reform, given the sheer size of derivative markets and the extent to which they constitute a large portion of the cross exposures between financial firms, must be done to render these exposures both transparent and simplified. A resolution authority cannot function with confidence when the spider web of exposures of an LCFI is opaque, complex and not properly valued.

America cannot end Too Big to Fail without derivatives reform. It is the San Andreas fault of the global financial system.

The use of mark to model accounting methods for OTC derivatives, particularly CDOs and the various concoctions of remixed CDOs, did not prove to be a reliable guide to their value in the marketplace. As a result, the value of assets and the resulting measures of firm capital adequacy were rendered invalid and subject to marked discontinuities in price. They gave no guide to the value of assets or the value of the firms holding them. When a LCFI is in trouble – and there are substantial holdings of complex and opaque OTC derivatives on the balance sheets of all of the LCFI firms – resolution authorities have difficulty unraveling the spider web of exposures and valuing them properly.¹⁰ A roadmap of exposures, both on the asset and liability side of the balance sheet, along with the valuation of those exposures, is key to understanding the implications for systemic risk in an LCFI resolution. Unfortunately, it is easy to understand why resolution authorities could be induced to forbear rather than resolve an LCFI when they have no clarity about its structure and patterns of exposures. In such a circumstance, it may be easier to incur the risk that the insolvent LCFI's balance sheet could continue to deteriorate. Simplifying derivatives – and making them trade on exchanges where there are real prices, and real margin set asides – clears the fog that currently surrounds the roadmap of exposures of an LCFI in danger of failing. It also gives authorities greater confidence in resolving the LCFI at least cost to the taxpayers.

These significant policy changes will be resisted, inevitably. A LCFI with a lucrative derivatives business benefits from the profit margin in complex derivatives. It also gains from customers' inability to discern their fair value when compared with simple transparent exchange traded instruments. The complexity of a derivative can deter competitive imitation and support profitability. It has been estimated that the 5 largest OTC derivatives dealers in the United States

(who are expected to earn more than 35 Billion USD from OTC derivatives in 2009) would lose 15 percent or more of those earnings if they were forced to clear them. They would lose even more when forced to trade on an exchange. Loss of earnings of more than six billion USD constitutes substantial impetus for those firms to resist proper reform. That is a socially tragic — the firms do not calculate the social costs associated with a riskier, more opaque and un-resolvable financial system that depends upon the taxpayer to bail it out in times of stress. Compounding the problem, that very prospect of taxpayer support tends to subsidize and engender overuse of these OTC derivatives that are created around the “OTC marketplace hubs” of the LCFIs.

Finally, it is important to comment on the specific role of credit default swap derivatives in the difficulties of credible resolution. Because naked CDSs¹¹ are permitted, and because they have been an unregulated segment of the market, the resolution authorities find it nearly impossible to comprehend the roadmap of contingent exposures that are triggered when a restructuring of a LCFI takes place. In the CDS market, Firm A can buy or write a CDS on LCFI Firm B with counterparty Firm C. The resolution of Firm B can then send one of the others, A or C, into jeopardy — and the authorities have little or no way of anticipating that consequence. As a result, the entire structure of the CDS market needs to come out of the dark to restore market integrity. For credible resolution, it is key to eliminate resolution authorities’ fear of unforeseen side effects that result from the “credit events” created by LCFI resolutions. We need comprehensive reporting of CDS positions to examiners and to a systemic risk regulator. We also need to confine LCFIs to using CDSs to insure a specific risk, thus prohibiting them from so-called naked buying of CDSs. These changes must be a part of derivatives reform if we are to restore market integrity.¹² LCFIs sit in a delicate position adjacent to the public treasury. That is why they should not be permitted to engage in the high intensity leveraged speculation that naked CDS positions offer.

LEGAL ASPECTS OF CREDIBLE RESOLUTION¹³

We must enact legislation to create resolution powers for the authorities that pertain to financial services holding companies, insurance companies and bank holding companies that would allow them to undertake prompt corrective action in response to an impending insolvency of one of these organizational firms in the event that it was considered a “systemic risk.” This should be done instead of proceeding under the traditional Bankruptcy Code or, in the case of registered broker dealers, the Securities Investor Protection Act (SIPA).¹⁴ The legislation should be designed to give the authorities an array of tools that the FDIC has with regard to a bank but does not have the right to exercise in the larger universe of financial institutions. The law should allow resolution authorities to utilize the tools that are available to the FDIC under the FDI Act. These include conservatorship, bridge banks, various forms of open bank assistance, liquidation, or assisted purchase and assumption.¹⁵

There are many reasons that new resolution powers could create lower-cost

bailouts, cause less systemic disruption, and permit authorities to be more confident in resolving an LCFI. First, a holding company may have solvent subsidiaries that could be sold off as going concerns and preserve value under the bridge bank structure that the FDI Act provides for. Under the Bankruptcy Code, this is a more cumbersome and lengthy process.

In addition, there is a class of exposures referred to in the law as Qualified Financial Contracts (QFC) that include certain swap agreements, forward contracts, repurchase agreements, commodities contracts, and securities contracts, and, importantly, derivatives contracts. They are not subject to the “stay” put on creditors at the time of insolvency that stop them from seizing assets. As a result, these “safe harbored” contracts can be closed out promptly. In periods of extreme market-wide stress, when many LCFIs are in jeopardy, the ability to transfer to a bridge bank or to place the QFCs with a going concern is likely to insure that a myriad of counterparties would not simultaneously close out their QFCs, thus igniting a distress sale in markets that would lead to extreme declines in prices. This, in turn, could feed back onto the balance sheets of the LCFIs and amplify financial stress leading possibly to further insolvencies.¹⁶

Advocates of giving derivatives QFI status argue that subjecting derivatives to the “stay” would lead many dealers who run a hedged derivatives book to take abrupt action when one side of that hedge entered into the bankruptcy process in order to rebalance their risk exposure. This could also lead to disruptive market behavior.

The entire legal structure surrounding derivative instruments, their priority in the event of insolvency, and the incentives created by making them QFIs to foment the use of derivatives relative to underlying securities, is a foundation stone in the architecture of the marketplace. The large cross-exposures between LCFIs that make it so difficult to resolve them without exacerbating financial contagion are fostered by making derivatives senior to other elements of the capital structure. The granting of QFI status to derivatives may have inspired a much more heavily-intertwined set of intra LCFI exposures than would otherwise be the case. While there may be some benefit from “netting” QFC derivative contracts in an insolvency and resolution during a closeout, it also appears that allowing long dated derivatives that are a close substitute for senior elements of the capital structure to “leap frog” to the top of priority leads to greater reliance on instruments that are currently poorly supervised and regulated. The risk of financial contagion must be diminished to permit credible resolution of LCFIs. Seen in that light, it may be necessary, as recommended earlier in this chapter, to put position limits on the cross-exposure between LCFIs to offset the incentives created by granting QFI status to derivative instruments.¹⁷

In summary, the legal creation of a resolution authority giving powers akin to those of the FDIC under the FDI Act – so that resolution authorities can treat systemically important financial organizations like the bank holding companies and financial services holding companies, insurance companies, and mega sized

hedge funds like the FDIC treats banks – aids the efforts to remove the obstacles to credible resolution of LCFIs. It is helpful to have proper powers, but nowhere near sufficient to enable the resolution authorities to use them when faced with an LCFI in distress.

INTERNATIONAL IMPEDIMENTS TO CREDIBLE RESOLUTION

Another challenge that deters officials contemplating the resolution of impaired LCFIs is their global presence. The LCFI often has a myriad of affiliates, branches and subsidiaries that inhabit a broad array of regulatory, supervisory and legal regimes around the world. Some of the affiliates are likely to be unregulated. This situation compromises the quality of information that the resolution authority is likely to have about the LCFI. It obscures the roadmap of exposures abroad and potential systemic spillovers.

There are several obstacles to obtaining a high quality portrait of the LCFI and its international positions and exposures. First, national supervisors tend to be very proprietary about sharing information. This is particularly true in times of crisis, when protecting the solvency of home country firms becomes paramount. Second, international supervisory regimes are quite heterogeneous with regard to the quality and frequency of information generated and reported. Third, there are many unregulated segments in the international marketplace. Fourth, some nations have secrecy laws, and some authorities are quite unwilling to share information with foreign authorities for fear of inappropriate leaks of proprietary information that is the essence of a home country firm's strategy and profitability.

Supervisors face a formidable set of challenges in developing a clear picture of the international context that surrounds a troubled LCFI. We recommend that the following challenges be met to inform and empower the resolution authorities and allow them to resolve a failing LCFI without unforeseen global consequences. The Resolution Authority needs:

1. A map showing the pattern of exposures emanating from the relatively small number of LCFIs around the world that can impact the American economy in the event of failure.
2. The cross-exposures between the troubled LCFI and other LCFI based in other countries.
3. The structure and positions of the troubled LCFI around the world, including an understanding the roadmap of affiliates, authorities having regulatory power over the affiliates, and legal regimes that are germane to the firms operation.
4. The contingency plans of communication between authorities around the world that are relevant to the failing LCFI and a plan for real time crisis management.

Fortunately, these challenges have been widely researched and discussed by a number of working groups within the Bank for International Settlement's Basel Committee on Bank Supervision Cross Border Bank Resolution Group, the

G20, the Financial Stability Board (formerly Financial Stability Forum), and the IMF and World Bank.^{18, 19} But the recommendation to invest in these systems to provide the authorities with information has yet to be emphatically embraced by political leaders.

A second impediment to resolution that emanates from the global reach of LCFIs is the difficulty of sharing burdens in credit restructuring across the different legal bankruptcy/resolution regimes in the different countries where the affiliates of the LCFI operates.²⁰ We have reached a time when the market for these behemoths is worldwide, and only a resolution regime that can treat creditors comparably, regardless of location, is sensible. The regime must be created to contribute to the credible ability of national resolution authorities to resolve and restructure LCFIs and require market participants who invest in them to bear the appropriate risk.

Harmonization of resolution regimes across the G20 is important for two reasons:

1. Any attempt by a national resolution authority to diminish the taxpayers' burden at home through the practice of restructuring of creditors of the LCFI must consider the power it has to impose debt for equity conversions or haircuts on the various types of creditors abroad. The resolution of the LCFI, using proper corporate finance methods, may be inhibited by this set of obstacles. The harmonization of resolution regimes across the major market centers (G20) is essential to ensuring that no national authority must choose between induced forbearance, with all of its potential dangers, and putting an undue burden on the domestic taxpayers of the home country of the LCFI in distress.
2. The harmonization of bankruptcy regimes across nations is also important to mitigate the credit-amplifying moral hazard characteristics of the incentives that are created for issuers of debt to concentrate their financing in locations where creditors are most insulated from restructuring risk and receive a lower yield on their liabilities as a result. The lower cost of funds that results from this bankruptcy resistance inspires more risk taking by the LCFI. It transfers burdens away from creditors and onto the back of taxpayers in the home country of the LCFI in the event of insolvency.

DETECTION OF INSOLVENCY

Once a credible resolution regime has been established, minimizing the taxpayer burden depends upon early detection of impaired institutions. The same information requirements that alleviate the fear of resolution authorities are also necessary to develop contingency plans for insolvency just as the LCFI crosses that line. The FDIC has a regime requiring prompt corrective action after several stages of warning indicators are breached to protect taxpayers and the other members paying into the deposit insurance fund from incurring the costs of a deeply insolvent firm.

To achieve early detection, the information requirements include the international challenges discussed, and also depend upon the real pricing of assets. Real pricing of assets depends upon simple and transparent positions that are readily traded. The earlier sections of this report on both off-balance sheet entities and on derivatives reform, which emphasized the benefits of simple transparent assets in assisting market function, monitoring and credible resolution, also benefits the process of preventing deep losses through early detection. The practice of mark-to-model on complex derivatives tends to be used to overstate the value of assets, and, as a result, the value of the capital of the firm. It thereby increases the risk that insolvency will not be detected promptly. The experience of the crisis of 2007-8 showed complex custom OTC derivatives to be subject to large discontinuous changes in reported value that often constituted the difference between full capital adequacy and insolvency.²¹ The revaluations occurred abruptly and the reports to examiners were far behind

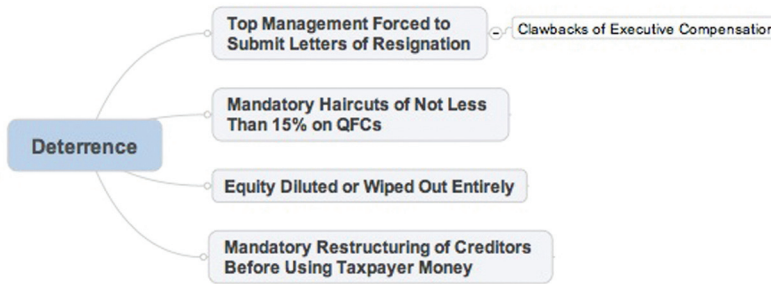


the curve in reporting real valuations. Similarly, the sudden reappearance of “liquidity puts” climbing back onto balance sheets from off balance sheet structures such as Structured Investment Vehicles (SIV) and Conduits lead to market deteriorations in capital from one day to the next. The requirements of high frequency reporting, transparent, simple and frequently valued assets based on real transacted prices, are imperative to early detection of an impaired condition at the firm. Chapters 8 and 9 on off balance sheet reform and the proper structure of derivatives markets address these issues in detail. In light of the burden borne by taxpayers in the recent crisis, there is absolutely no excuse for perpetuating market structures that continue the risks society bears because of opacity.

DETERRENCE

It is characteristic for the resolution authorities to request complete discretion in responding to the challenges of a financial crisis. Yet when they appear to engage in actions that do not seem to protect the people they were elected/appointed to represent, the question of enacting rules that constrain their methods of resolution begin to look more palatable and/or necessary. In this respect, rules that mandate dilution, if not the wiping out of equity of the

impaired LCFI; use of creditor restructuring of debt into equity before any taxpayer money can be touched; mandatory haircuts on Qualified Financial Contracts of up to 15 percent; and mandatory resignation/firing of top management along with potential claw-backs of deferred compensation, can all serve to protect taxpayers. They can also deter top management from crossing into the zone where they depend upon financial support from the public treasury. In a world where money politics, campaign contributions, and lobbying are rampant, we cannot rely on a cops-and-robbers regulatory regime and the willingness of the financial cops to impose pain upon the powerful and wealthy members of the financial sector. It may be better to enact into law deterrent policies that inform creditors, counterparties, management, and stockholders that they will pay a price – with certainty – in the event of insolvency.²²



The debate on rules versus discretion in economic policy-making is applied in many realms. Tying the hands of officials can make expectations of outcomes binding and make the deterrent to excessive risk taking more credible. Given the scale of resources involved, the incentives of LCFI and their top management to lobby and fund political candidates to appoint their favorite crony regulators are enormous. When the policy discretion of a Treasury Secretary, Fed Chairman or FDIC Chairman is diminished by the introduction of mandatory rules of resolution, it takes some of the energy out of the potential political “payoff”. Your favorite crony can no longer alleviate the pain of failure on your behalf. A rules-based regime at the margin also discourages that unseemly and unproductive investment of social resources into lobbying to influence government policy to garner superior private returns.²³

CONCLUSION

Insolvent institutions have to be able to fail. The integrity of the market system depends on it, so we need credible resolution of insolvent financial institutions. Because of the widespread spillovers (externalities) emitted by LCFIs, a process of reorganization is not simple. Of course, we should have preventative measures, including substantial capital requirements; examination and supervision

with vigor and resources; restrictions on the nature or scale of activities that such institutions can undertake; and limits on the exposure of an LCFI to any one counterparty. In addition, we can put in place elements of our resolution regime that are rule-based penalties triggered by insolvency, thereby diminishing the moral hazard associated with the prospect of government support for loss mitigation in a financial crisis. Yet even with preventative medicine, we will on occasion experience the failure of LCFIs with global reach. We need to be able to shut them down, break them up or restructure them.

To do that we need:

- Simple transparent markets
- International agreements on uniform resolution regimes
 - Substantial cooperation internationally in information and production pertaining to LCFI
- Legal methods to resolve LCFIs whatever their organizational structure
- The ability to close LCFIs without bringing down the entire financial system
- The information requirements of these recommendations are formidable and the legislative changes substantial.

It is bad policy to be induced to forbear with the LCFI and then subject society to the impaired credit and aggressive practices of desperate insolvent financial institutions whose fear of being put out of business drives them to impose abusive fees, 30 percent interest rates on credit cards, and block housing foreclosure modification to hide their fragile condition for prolonged periods of time. The economy can regain strength if it is not forced to bear the burden of waiting for the balance sheets of LCFI to be rebuilt by the resources they extract from all of us in a long run of forbearance.

Our society, both in the United States and in other major countries, has yet to come to grips with the challenge that these LCFIs pose to the integrity of our system. It will take substantial resources – albeit small in compared to our losses in the recent crisis – to invest in high frequency, comprehensive and global information gathering for the supervision and regulation of LCFIs.

We must undergo a substantial change in social norms to recognize the legitimacy of demands from well-paid examiners and supervisors to get the information from financial firms that are necessary to govern our financial system. The firms are not doing the nation a favor. Their compliance is compulsory and laws have to be enforced.

We must also summon political will. It will take formidable leadership to pass international agreements for coordination of crisis response, mandate information sharing, and make agreements to harmonize resolution regimes across countries.

Many elements of a healthy design of the domestic and international financial system have been developed, refined and were clearly understood by experts on finance and markets long before this crisis of out of control markets erupted in 2007-8. The design of proper reforms is not too complex to understand. It is not beyond comprehension. The primary ingredients, as outlined in this report, are well understood. They are essential to the confidence and integrity of American capital markets. It is well beyond time to enact them and to enforce them. Finance is a means to serve the economy and society. It is not an end in itself.

ENDNOTES

1. See Chapter 1 on the Doom Loop by Simon Johnson for a discussion of the distortions and dangerous consequences of not having LCFI fail.
2. This schizophrenic approach to financial regulation and resolution has damaged the credibility of financial sector leaders when they assert that they, and they only, have the expertise that entitles them to be architects of their own domain.
3. Just the simple notion that protecting the taxpayers in one country may require officials to tolerate greater risk of systemic risk propagation to counterparties of their LCFI based in other countries illustrates the tradeoffs that we face. See Eugene Fama, Government Equity Capital for Financial Firms, at <http://www.dimensional.com/famafrench/2009/01/government-equity-capital-for-financial-firms.html>
4. Also see Piero Veronesi and Luigi Zingales, Paulson's Gift, at http://faculty.chicagobooth.edu/brian.barry/igm/P_gift.pdf A historical survey of bailouts and restructuring of failed financial institutions with a comparison to the U.S. bailout performance in 2008-9 is provided by the Congressional Oversight Panel of TARP. Available at <http://cop.senate.gov/documents/cop-040709-report.pdf>. See also the unpublished working paper by Charles Ledley, Jamie Mai, and Vincent Mai, distributed to staff and members of the House Financial Services Committee, the FDIC, the Federal Reserve, and the Treasury Department.
5. Forbearance is the term used to describe when officials choose not to restructure or liquidate an insolvent firm. In essence they are avoiding concrete action and betting on a rebound of the firm and a return to solvency. The risk of forbearance is that the firm continues to deteriorate and the losses that eventually must be restructured are larger.
6. Note that the TARP round of capital injection simulated this kind of resolution and fortification action but skipped the step of thorough examination. A certain amount of money was used to fortify firms but the marketplace did not get the kind of reassurance that would have been created by the knowledge that the capital injection was derived from examinations and that the system was sound again.
7. I am skeptical about so called "Living Wills" where the firms are asked to provide the roadmap of their own exposures for authorities. They in fact have little incentive to provide a helpful document when they have the knowledge that a good document will make it more likely that their stock and stockholders share certificates can be wiped out. The roadmap must be prepared by the examiners that have full access to the records and systems of the LCFI in question. The practice of requiring a living will seems to be an attempt to get around difficulties of coordination between regulatory authorities who are reluctant to share information and defend their home turf in times of financial stress.
8. Of course such a rule must be part of a much more comprehensive reform of campaign finances and lobbying. It cannot apply strictly to the financial industry. The recent experience with healthcare reform in the United States, and the difficulties the government is having addressing climate change suggest that a wide sweeping change is called for. The recent Supreme Court decision in the case of *Citizens United vs. FEC* increases the urgency of such reforms.
9. Much of this connection between inadequate regulation of OTC derivatives and their interconnection with LCFI and resolution policy was spelled out in the 1990s by Alfred Steinherr in his provocatively titled book, *Derivatives: The Wild Beast of Finance*. See also the work of Garry Schinasi and his colleagues at the IMF. See especially, *Modern*

Banking and OTC Derivatives: The Transformation of Global Finance and its Implications for Systemic Risk, Occasional Paper 203, 2000.

10. See the quarterly derivatives report of the Office of the Comptroller of the Currency. Five institutions, JP Morgan/Chase, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley account for over 95 percent of the notional value of derivatives exposures of the universe of U.S. bank holding companies.
11. Mason Fleury explains: "A credit default swap is a protection against default of debt. If you can hold a bond, you can buy 'protection' against default. You buy a premium, and if the bond defaults you get the principal back. If you don't hold the bond, then it is called a 'naked' CDS. You pay the premium on a fictitious bond (you never paid the principal) but if it defaults, you get paid the principal, poof! out of bad debt comes more bad debt." See <http://www.thedelphicfuture.org/2009/01/cds-are-good-naked-cds-are-bad-ok.html>.
12. I do note that in July of 2007 Fitch Ratings put out a report that identified a very large concentration of CDS written by AIG Financial Products. Serious analysts in the private and public sector had no reason whatsoever for not understanding that AIG was accumulating these positions at that time. Fitch's report is free online.
13. For well developed exploration of many of these issues see the report from the Committee on Capital Market Regulation entitled "The Global Financial Crisis: A Plan for Regulatory Reform," Chapter 2 section D pages 112 to 127. Available at
14. U.S. Dep't of the Treasury, "Resolution Authority for Systemically Significant Financial Companies Act of 2009" (Mar. 2009), available at <http://www.ustreas.gov/press/releases/reports/032509%20legislation.pdf>.
15. One of the difficulties associated with the LCFI is that the P&A is that there are unlikely to be buyers for the entirety of such large entities given their size, and that continued aggregation is likely to run into conflict with concerns about concentration, aggregation and anti trust concerns. These costs are rarely an explicit part of the calculus in the midst of a crisis.
16. See again the CCMR Report, *The Global Financial Crisis*, Chapter 2, section D, and also *Derivatives and the Bankruptcy Code: Why the Special Treatment?* by Franklin Edwards and Edward R. Morrison, *Yale Journal on Regulation* Volume 22 pp 101-133. Also see *Over the Counter Derivatives and the Commodity Exchange Act* by The Presidential Working Group on Financial Markets, November 1999.
17. See Secret Liens and the Financial Crisis of 2008 by Michael Simkovic, *American Bankruptcy Law Journal*, Vol. 83, p. 253, 2009
18. One can readily see that these challenges pertaining to cross border resolution policy have been studied and analyzed with growing depth and sophistication since the failure of BCCI in 1991. It is somewhat disheartening to read the historic series of reports on international bank resolution challenges, many written well before the crisis of 2007-8, and see how little of this has work has been actualized and made operational. Many of these reports recommendations, had they been implemented in the major market centers, U.S., UK, EU, Switzerland, and Japan, would have certainly given the officials better picture of what was unfolding and more confidence in addressing resolution as the crisis unfolded. It is encouraging that the Financial Stability Board's Cross Border Crisis Management Working Group under the Chairmanship of Paul Tucker, Deputy Governor of the Bank of England, is pressing forward on this agenda once again.
19. Some excellent papers have been done on this subject at a variety of institutions. See for instance, New Financial Order, Recommendations by the Issing Committee, Prepared for the G-20 in February 2009. Regimes for Handling Bank Failures: Redrawing the Banking Social Contract by Paul Tucker, Deputy Governor of the Bank of England, June 30, 2009. Available at <http://www.bankofengland.co.uk/publications/speeches/speaker.htm#tucker>. Also by Tucker see "The Crisis Management Menu, November 16, 2009. In the speech Tucker emphasizes the ongoing work by the FSB, the Financial Services Authority of the UK and historic work at the BIS dating back to the closing of BCCI. It appears quite clear from the writings of the Governor of the Bank of England, Mervyn King, Deputy Governor Tucker, Andy Haldane, and Adair Turner at the FSA that the British efforts to address the LCFI resolution problems, both domestic and global go far beyond what the Federal Reserve Board and U.S. Treasury have proven willing to address. Within the United States Sheila Bair, the Chairperson of the FDIC and her staff have been the most imaginative in addressing these challenges. Michael Krimminger at

the FDIC has written a number of papers on the themes discussed here and serves on the BIS Cross Border Banking Resolution Group. Also see the prescient work by Garry Schinasi including *Safeguarding Financial Stability: Theory and Practice* (Washington, DC: International Monetary Fund) 2006.

20. See for instance, *Report and Recommendations of the Cross-border Bank Resolution Group*, Basel Committee on Bank Supervision, September 2009. Online at <http://www.bis.org/publ/bcbs162.htm>
21. Lehman Brothers was reported to be well capitalized the day before they ceased operations in September of 2008
22. Many have noticed the heads financiers win - tails the taxpayer loses system of limited liability that the current taxpayer backed system provides. Lucien Bebchuk and others have suggested that top management is drawn to excessive risk taking and that a modification of their payoff incentives in those states of nature when the firm becomes insolvent may be a way to keep management out of the magnetic field of lemon socialism's attractions. See Bebchuk and Spamann, *Regulating Banker's Pay*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1410072
23. See Thomas Ferguson's *Golden Rule, The Investment Theory of Party Competition and the Logic of Money-Driven Political Systems* for more on the extraordinary role that money and business power has had in shaping American political outcomes.

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The views expressed in this paper are those of the author and do not necessarily reflect the positions of the Roosevelt Institute, its officers, or its directors.

THE ROOSEVELT INSTITUTE

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For decades, the Roosevelt Institute has been devoted to carrying forward the legacy and values of Franklin and Eleanor Roosevelt. Whether celebrating leaders who have embodied the Roosevelts' ideals or empowering emerging leaders to build a more progressive future, the Roosevelt Institute protects and promotes the vision of Franklin and Eleanor Roosevelt.

The Institute is the nonprofit partner to the Franklin D. Roosevelt Presidential Library and Museum in Hyde Park, New York, and supports the Library's exhibits, educational programs, and special initiatives. The Institute is also home to the Roosevelt Institute Campus Network, connecting 80+ college campuses and more than 8,500 students and alumni to a vibrant series of programs that engage them in discussing progressive values, empower them to develop public policy, and promote their ideas to policymakers at all levels of government.

In addition, the Roosevelt Institute Policy Center supports some of the most creative and well established progressive voices as they engages the fundamental policy challenges of our era. The Center began its work in 2009 with projects focused on financial sector reform and the future of the global economy. Senior fellows include Nobel-prize winning economist Joseph Stiglitz; Robert Johnson, former chief economist to the Senate Banking Committee; and Bowman Cutter, a former senior Clinton and Carter administration official. With an eye on the future, the fellows of the Roosevelt Institute focus on important questions around how to frame and shift broad policy paradigms - not just narrow details that often dominate the day-to-day of policy making. The fellows - young and old - are inspired to carry forward the courage and values that Franklin and Eleanor Roosevelt brought to key points in the 20th century.

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with it. Credit contracted. Industry stopped. Commerce declined, and unemployment mounted. . . We know well that in our complicated, interrelated credit structure if any one of these credit groups collapses they may all collapse. Danger to one is danger to all. How, I ask, has Washington treated the interrelationship of these credit groups? The answer is clear: it has not recognized that interrelationship existed at all. Why, the Nation asks, has Washington failed to understand that all of these groups, each and every one, the top of the pyramid and the bottom of the pyramid, must be considered together, that each and every one of them is dependent on every other; each and every one of them affecting the whole financial fabric? Statesmanship and vision, my friends, require relief to all at the same time. . . What do the people of America want more than anything else? To my mind, they want two things: work, with all the moral and spiritual values that go with it; and with work, a reasonable measure of security - security for themselves and for their wives and children. Work and security - these are more than words. They are more than facts. They are the spiritual values, the true goal toward which our efforts of reconstruction should lead. These are the values we have failed to achieve by the leadership we now have. . . Leaders tell us economic laws - sacred, inviolable, unchangeable - cause panics which no one could prevent. But while they prate of economic laws, men and women are starving. We must lay hold of the fact that economic laws are not made by nature. They are made by human beings. . . Give me your help, not to win votes alone, but to win in this crusade to restore America to its own people.

Franklin D. Roosevelt

Chicago, 1932

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