5 J.L. Econ. & Pol'y 259

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THE LATEST IN THE FINANCIAL SERVICES CRISIS: GOVERNMENT CONTROL v. THE FREE MARKET TRANSCRIPT

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Welcome and Introductory Remarks

HONORABLE DOUGLAS H. GINSBURG: Welcome to this afternoon's panel on the problems in the financial sector. We have a large number of panelists who are going to speak to us to get this kicked off. Each one's going to speak for five minutes, and it is my job to make good on that promise.

I am designated the moderator. I feel more like the impartial referee at a meeting of Christians and lions, but I am going to do my best to keep [the panelists] in line.

The credentials of our speakers are unsurpassed, and they are available to you in writing, so we are going to spend essentially no time telling you where they went to school, but I assure you they all went to school. I will tell you their present affiliations and the order in which we're going to hear from them.

We will hear first from Peter Wallison, who is a resident scholar at the American Enterprise Institute (AEI); then from Bert Ely, chairman of Ely & Company Consulting; and from John Taylor of the National Community Reinvestment Coalition (NCRC); and on my immediate left, Professor Todd Zywicki, George Mason University School of Law; then we will hear from Alex Pollock, also at AEI; and from Andrew Redleaf of Whitebox Advisors. [1]

With that said, I am going to start the stopwatch. If there are a few people who are old enough to remember a TV game show called “Beat the Clock,” in which each person or contestant was given some absurd task to perform such as an egg-in-a-spoon walk and that sort of thing before the clock ran out, we are going to ask each of our speakers, in five minutes, to tell us what's happened, why, and what should be done about it.

***260** Peter, it's all yours.

Panelists' Remarks

PETER J. WALLISON: Thank you, Your Honor. It's a pleasure to be here. Actually, I'm still going to school on what we're facing in this economy. I'm learning every day, and I'm not sure what I'm going to say today is my final view on the subject. But we have what is simply an extraordinary event—a series of events—unfolding before our eyes, and we can all learn a tremendous amount by thinking carefully about what this all means.

As a person who deals with policy, I want to make sure that we understand the essence of this crisis. The diagnosis of where we are and how we got here is exceedingly important because it's the diagnosis that produces what is ultimately the prescription. So, I hope you will all be thinking about how we got here and what you hear from the other people on the panel because that is really what is required to understand this crisis. I'm going to advance some ideas about what I think caused the problem we're in, and I hope I can do it within the, now, four and a half minutes that I've been given by His Honor.

My general view is that the problem we are facing today is almost entirely the result of government policy. There are five major elements that have made financial conditions worse today than anyone might have expected, but only because government policy forced our economy into positions that it would not have been in had that government policy not existed.

These are the five elements: the first is that the government has attempted to expand homeownership, but it has not done it in an honest way. I have no quarrel with that policy because there are a great many exogenous benefits that come from more people owning homes, but instead of providing for some kind of subsidy for people who could not otherwise afford a mortgage, the government manipulated the financial system.

In the case of banks, it used the Community Reinvestment Act (CRA), and in the case of Fannie Mae and Freddie Mac, HUD's rules on affordable housing loans, to force banks and Fannie and Freddie to acquire subprime and Alt-A loans. We now have trillions of dollars of those loans scattered through our banking system and the banking systems of the rest of the world. That is the central reason why there is concern about the stability, the quality of the assets, and maybe even the solvency of many of our largest banks and many of the banks around the world.

The second element is that the CRA, and to some extent Fannie Mae's and Freddie Mac's operations, caused a real change in the quality of underwriting for loans. In order to make loans to people who were not otherwise able to meet down payment and other standards, many new ideas—flexible ideas—were developed for mortgage lending: interest-only loans; adjustable-rate loans; negative amortization; and loans with no income test. In some cases, loans were made on the basis of the FICO score alone. All ***261** of those things tended to depreciate, if you will, the quality of underwriting for mortgages and the quality of the mortgages themselves. Loans were made on the basis of reduced or no down payments. This reduced the equity that was behind a mortgage when someone bought a home.

The third element is an option to refinance which is allowed in our law almost everywhere. This is an unusual thing. It's not something that's a natural right; you don't always have an option to refinance without paying a premium. However, this idea is now imbedded in our law, and whenever interest rates go down or housing prices go up, people rush to refinance their homes. This also enables them, through cash-out refinancing, to draw equity out of their homes, to buy a boat, a second home, or whatever else it was that they may want. So, that also reduced the actual equity behind the mortgage.

The fourth element is a tax policy that allowed interest on home equity loans to be deductible. Now, as you know, unless you're in business, the interest that you pay on borrowing is not tax deductible. But if you're a homeowner and you have equity in your home, you can borrow against that and use it to buy a boat. Many, many people did that and again reduced whatever equity they were able to accumulate in their homes so that a very large number of the homes in the United States don't have any significant equity behind the mortgage.

Finally, the fifth and I think the final element is bank regulation. Under the Basel regulations, banks were required to hold only 4% capital against their mortgages whereas they have to hold 8% capital against a commercial loan. This difference gives banks an incentive to make and hold more mortgages than they might without the capital advantage. In addition, if a bank turns its mortgages into a pool backing mortgage-based securities, and holds those securities instead of the mortgages, it only has to hold 20% of the capital requirement, which is 1.6%, behind a portfolio of mortgage-backed securities.

So, you see what's happening here: the equity behind the home loan has been drawn out of the homes. The equity in the banks, which used to come from capital requirements for banks, has gradually been drawn out of the banks by regulatory policies. As a result, we have very little equity or capital in a system that is intended to protect the solvency of mortgages and even the solvency of banks. So, that's the cause of the problem, and it is solely the result, I think, of various government policies. So, that's the diagnosis. Now we get to the prescription, and that I'll leave to all of my colleagues.

Thank you.

BERT ELY: Thank you. I'm Bert Ely, and I'm very glad to be here with you today. You're going to hear from me some of what Peter said, and I'm going to go beyond it in some other ways.

***262** What I'm drawing my remarks from is a paper that I'm working on called “Bad Rules Produce Bad Outcomes.” This paper will address the underlying public-policy causes of the U.S. housing finance crisis.

The key thing I do in this paper is talk about what I call the collision between the physics of finance and human nature. What I do in this paper first is identify five human characteristics—five aspects of human nature—that have become particularly relevant with regard to the housing finance crisis. I'm just going to list those very briefly and then touch on, so far, eleven causes that I've identified of this crisis that lie in the public sector.

First of all, it's human nature for people to try to arbitrage the rules of the game; the more complex the rules are, the more arbitraging there will be. If there is ever an area of complex rules, it is in finance and in banking. The second aspect is that people tried to profit from a positive slope in yield curve. That is, short-term interest rates are usually lower than long-term interest rates. That ultimately is what set us up for the S&L crisis back in the 1980s, and it has been a factor in the current financial crisis. The third aspect concerns over extrapolating trends. [For example,] housing prices are going to go on forever; they'll never come back; the stock market will go up and up and up; or as we may now say, down, down, down, down. And then from that comes herd behavior, which we've certainly seen in the housing area. The final aspect is an excessive reliance on expert opinions such as those offered by the rating agencies. So, what I offer in this paper in looking at the eleven causes are, if you will, solutions and policy recommendations that build on those characteristics—those aspects of human behavior that we have to recognize.

Now, what do I see as these causes? First is the Internal Revenue Code, and not just on the housing side, as Peter talked about, but also on the corporate side. We have a tax system that encourages over consumption, discourages savings, encourages over leveraging by both households and businesses, and under encourages the accumulation of equity capital that is not debt capital. Consequently, we have an over-leveraged society in the business, banking, and the household sectors which is why we're in the problems we are and always end up in problems any time you have a downturn in asset values.

Second, as Peter also touched on, is banking regulation, particularly very detailed prescriptive and proscriptive regulation. Some will argue that the cause of this crisis is substantial deregulation of recent decades. I'd like to have people tell me what exactly that was. We still have a more highly regulated banking/financial system than we've had before, which created a lot of incentives for people to try to arbitrage around the system, creating what I call the world of shadow banking—that is, credit and remediation outside the banking system.

Third, we have policies that discourage maturity mismatching, which is particularly important in terms of providing stability and financing long-term fixed assets like home mortgages. Fourth is fair-value accounting. ***263** Fifth is the fact that the credit default swaps that are increasingly seen as a problem oftentimes don't have an insurable interest behind them, and I would argue that that's really nothing more than gambling. The question should be raised as to whether a credit default swap is enforceable if there is no insurable interest. Sixth is fixed-price deposit insurance, specifically in terms of an under-pricing for risk that banks have accumulated. A lot of the bank failures today are among banks that were excessive in their risk taking. Seventh is the First Amendment protection for the credit rating agencies providing that they can't be sued for negligence. The accounting firms give opinions, and they get sued. Some of them even go bankrupt. The same should hold for the rating agencies. Eighth is government-sponsored enterprise, particularly Fannie Mae and Freddie Mac that Peter already talked about.

Ninth is the over promotion of homeownership. For a long time, the homeownership percentage in this country hovered around 64%. In recent years, it got pushed up to 69%, and that's when we saw the outburst of subprime lending. As one who is a longtime renter, I am frankly getting tired of being treated as a second-class citizen because I have voluntarily decided not to own a home. I hire good landlords. I think we need to be more respectful of rent.

Tenth is the Glass-Steagall Act, and the eleventh is monetary policy. There are a couple of others that I have been thinking about such as, in many states, non-recourse obligations on the part of homeowners who default on their mortgages.

With that, I will close it off. I look forward to our discussion and your questions.

Thank you.

[Applause]

JOHN TAYLOR: Good afternoon. The title of Bert's paper—and I love Bert—is "Bad Rules Produce Bad Outcomes." I read that paper, and I think there're a lot of good things in it. It also helped me create the title for my own paper, "Bad Rules Don't Produce Bad Outcomes, Bad People Do."

[Audience laughter]

I'm really borrowing that from the Second Amendment advocates. You know, "guns don't kill people, people kill people." So, for me, it wasn't the rules and regulations relative to our economy, but it was those people, again, who killed our economy. Those folks in the private financial services sector who abandoned or perhaps some of them who never had any ethical standards to begin with that led the mortgage industry down a path that promoted and encouraged deceptive and predatory lending.

***264** The regulatory agencies—more people charged with ensuring fairness and ethical standards in the safety and soundness in our lending system—failed in their responsibilities. It was actually sad for me to watch the former Chairman of the Federal Reserve, Alan Greenspan, being grilled by members of Congress for his free market assumptions. In the end, a humbled Mr. Greenspan admitted that he had put too much faith in the self-correcting power of the free markets and had failed to anticipate the self-destructive power of wanton mortgage lending: "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."

Those segments of the mortgage industry that led us on this path to disaster were actually two of the most under-regulated, nontransparent, and unaccountable segments of the entire mortgage industry: independent mortgage companies and Wall Street institutions. The independent mortgage companies operated with little or no regulatory oversight. The CRA did not apply to them. By the way, depending on whose statistics you want to look at, whether it's the Federal Reserve's or others', you'll see that between 83% to 85% as much as 90% in some studies show the loans that are now problematic—these high cost [loans] that are going into foreclosure and are causing problems—were not CRA-generated loans. They were not done by CRA institutions. I'm surprised AEI doesn't understand this. Perhaps the story will change on this.

But the folks who did this were obviously not the typical banks and folks who were the mainstay of the mortgage industry at one time. So, these independent mortgage companies could market, almost unimpeded as history has shown us, one product after another to minority neighborhoods and another product to white neighborhoods. Banks were more scrutinized in this matter, and it's one of reasons why banks were relatively slow to embrace the subprime lending with its multiple-list layering. When they did follow the independent mortgage companies down the path to the spurious lending, they did so via their subsidy institutions —again, most of which were outside the purview of the CRA and its examiners.

Complex and sophisticated instruments for derivatives allowed for leveraging credit based on the layering of risk supported by an assumption of never-ending housing value inflation. Mortgage lending, historically one of the cleanest and safest loans made by the financial service sector, had its performance horizon revised from thirty years to three months. Lenders who worried about the long-term portfolio performance would be replaced by those who needed to have the borrower survive and make payments only for a few months. Short-term fees replaced long-term payoffs as the business model for the mortgage industry. The pipeline for such behavior was expanded by the investment banks—flush with capital—in search of any investment. Regulation? What regulation?

To be fair, there are other collaborators in this free market gone wild. Property appraisers did their part by adjusting property values according to ***265** lender, broker, and seller desires rather than simply using their independent valuations, processes, and systems. In return, the appraiser got their fee and more business from that broker or lender. While the law required independence and arm's length transactions between appraisers and lenders, nearly 95% of all appraisers have admitted that they were regularly influenced to adjust home valuations by the broker or the lender. In many instances, the mortgage companies, like Countrywide Home Mortgage, owned the appraisal company that they used.

Independent mortgage brokers drove much of the malfeasant lending train, and in most states, getting a lender to offer mortgages was as easy as procuring a driver's license. Requirements relating to brokers, their own financial condition, credit history, criminal history, business history, and prior legal problems were nonexistent in most states. Education courses were offered—many online with little or no continuing education requirements. In most states, while brokers could be licensed in that state, they didn't need to have their principal business in that state. Almost no state gave brokers a duty or responsibility to secure and offer loans that were reasonably advantageous to the borrower. Few states had meaningful enforcement authority available that would have allowed them to rein in unscrupulous brokers. Regulation, oh regulation, where art thou?

Mortgage lenders knowingly collaborated with these appraisers and brokers to push mortgages that were layered with risk upon risk and with less documentation about the borrowers' financial ability by merely assessing the borrower's ability to repay the loan for only the first two or three years at which time the loan features reset. At loan closings, lenders had borrowers sign documents revealing negative amortization and promised the borrower that home-equity appreciation was a sure thing and that the road to salvation out of the current loan was via refinancing rates when the rates would be lower and their property value greater.

All this, they promised, would occur in less than two years. They assured the nervous borrowers with statements like “this is how you build wealth sooner; this is how everybody is doing it.” In fact, in many instances, we found that they actually encouraged borrowers to take out a larger loan for a larger home and encouraged them to go look for something more than what they were even originally coming into the lender for. Regulation, oh regulation, where art thou?

Let's not dismiss the role of the rating agencies that willingly slapped AAA and AA and other ratings on these securities implying a level of integrity and due diligence even though such decisions were based solely upon the representations of the lender, the institution paying for these rating agency services. We believe these rating agencies substantially contributed to the housing foreclosure crisis in African-American and Latino communities by making public misrepresentations about the soundness and reliability of these subprime securities. Regulation, oh regulation, where art thou?

***266** Finally, we have the investment banks telling the entire mortgage industry—to paraphrase and distort Emma Lazarus' great historic line, “Give me your tired, your poor, your huddled masses yearning to breathe free.” Instead, from Wall Street investment firms we got, “Give me your pay-option adjustable-rate mortgages (ARMs), your no or low documentation pile of poorly written loans. Send me the wretched refuse of your teeming origination process. Send all these and more to me.”

[Audience laughter]

In the end, we continue to learn several lessons from the mortgage meltdown. Chief among them is that there is a nexus between safe and sound lending and abusive lending. When greed and malfeasance are able to dominate the business sector and when middle-class and moderate-income lending abuses are ignored, we all lose. Today, the main culprits have sealed their own demise with all the major independent mortgage companies gone—AmeriQuest, Option One, New Century, Countrywide. So, too, are many of the major investment banks, either gone or reduced.

I'm going to leave out my stuff about Phil Gramm because I'm running out of time. We can talk about him another time, but I do want to close by just saying in the Wealth of Nations, Adam Smith tackled the question: what makes an economy grow? He spoke to the need of a free market with liquidity and free trade, but he was also emphatic about the rule of law—that the rule of law must be present to ensure the fairness and integrity of the market. Alan Greenspan, in his latest book Age of Turbulence, stated that reputation and the trust it fosters have always appeared to be the core requirements of market capitalism. The rule of law and trust were missing from the subprime mortgage lending industry during the years 2003 to 2007 when the majority of these deceptive and predatory loans were allowed to pollute the American mortgage market.

Still today, Congress has not acted to outlaw these practices, and I hope that the next administration will address this. I look forward to more discussion during the Q&A. Sorry for taking too much time.

[Applause]

PROFESSOR TODD J. ZYWICKI: We certainly live in historic times, by which I mean in the final month of the Bush administration, the Washington Post has finally found the cabinet official that they like: Hank Paulsen. He was recently praised for putting aside his close-minded ideology, waking up to the real world, and being more pragmatic in tackling the world as opposed to being a slave to free-market views.

But we're also in historic times, obviously, with the financial crisis. I used to refer to it as the subprime crisis, but the more I explore it, the more I realize it's really a mortgage crisis sort of situation. What I'm going to ***267** talk about just briefly is three theories of foreclosures, what's going on, and in particular, what they tell us about the possibility for unintended consequences with respect to interventions in the mortgage market because what we'll see is these three different theories cut at cross purposes sometimes.

The three basic theories are: one, problems of local macroeconomic distress; second, particular problems with adjustable-rate mortgages; and third, a negative equity problem or what we could think of as a put option with respect to how consumers use the option to allow default and foreclosure. Basically, it turns out, if you look at how consumers actually behave over the long run and in the aggregate, they behave quite rationally which tells us something and warns us against the way we want to intervene.

So, the first problem we have is basically local macroeconomic distress. This causes foreclosures. The earliest surge in the foreclosure problem this time came from Michigan, Ohio, and Indiana; basically, where we've had long-standing macroeconomic problems. Whenever we have a natural disaster it leads to foreclosures. Now, one thing that's interesting about that is that when homes are underwater people are reluctant to move and relocate. So, one unintended consequence of trying to prevent foreclosures—which is a good in and of itself—may be setting back labor market mobility and the flexibility of people to move around in the economy. So, sometimes foreclosure does involuntarily what people don't want to do voluntarily, which is basically give up their house and move to a part of the country where the economy is growing and they can get a better job.

The second theory is basically adjustable-rate mortgages. I brought some handouts that didn't get handed out, so I'll just hold this up and maybe the camera can pick it up a little bit.

[Audience laughter]

Basically, this handout shows the trend over time. The top line is fixed-rate mortgages, and the bottom line is adjustable-rate mortgages or an aggregate sort of thing. What you notice is a couple things: first, there's a general downward trend since 1984; second, in general, there's about a 100 to 150 basis-point difference between adjustable-rate mortgages and fixed-rate mortgages. What does that mean? Basically, what it means is, if you get a fixed-rate mortgage, you have to pay the bank to bear the risk of interest rate fluctuations. Adjustable-rate mortgages you bear the risk.

Now, what does that mean? Over time, we note divergences between short-term interest rates and long-term interest rates. What we see is the consumers' response to those incentives, which is that as the spread between short-term interest rates and long-term interest rates increases, people flip from fixed-rate mortgages to adjustable-rate mortgages. This is a scenario that predates anything involving the subprime mortgages. If you look at this chart, what you see, for instance, is that 61% of the mortgages that were written in 1984 were adjustable-rate mortgages. In 1988, there were ***268** 58%. In 1992, there were about 50%. Consumers respond to the differences between adjustable-rate mortgages and fixed-rate mortgages.

So, why has this not been a problem in the past? Well, the reason it hasn't been a problem in the past is that adjustable-rate mortgages and short-term interest rates have dropped below fixed-rate mortgages, and fixed-rate mortgages have come down from the adjustable-rate mortgages over time. What happened this last time, though, was the Federal Reserve pushed adjustable short-term interest rates very low—artificially low—and fixed-rate mortgages stayed flat. What happened is, instead of fixed-rate mortgages coming down, adjustable-rate mortgages went back up, and all of the sudden, we've got an adjustable-rate mortgage crisis that's not just a subprime crisis.

So that if you look at the data for subprime mortgages, the top line is adjustable-rate mortgages for subprime. What you see is they take off over the past two years. The bottom line, which represents fixed-rate subprime mortgages, is basically flat. Fixed-rate subprime mortgages have not exhibited the same sort of problems as adjustable-rate mortgages. Now, that's partly because subprime borrowers who got fixed-rate mortgages were a marginally better risk than those who got an adjustable rate. But, what you see is, we've got an adjustable-rate mortgage problem when it comes to subprime mortgages— not a hybrid problem. The best empirical evidence we have indicates that it's not a problem of the short-term opening because those mortgages tended to refinance.

But if you look at the prime-rate mortgages, you see the same thing. Prime mortgages have behaved the same way as subprime, which is, we've got an adjustable-rate mortgage problem when it comes to prime mortgages. So, what you see is that foreclosures on prime adjustable-rate mortgages have risen 300% over the past couple years. Fixed-rate prime mortgages have been basically flat, so we do have something that is an adjustable-rate mortgage problem. In and of themselves, adjustable-rate mortgages aren't the problem, but when you put an adjustable-rate mortgage together with the monetary policy we had from 2000 to 2004, you get the problem that we have today.

The rest of the world has adjustable-rate mortgages with ten to fifteen year terms and no right to prepay. The United States is unique, as Peter suggested, in the kind of mortgages that it offers. There's nothing inherently problematic with adjustable-rate mortgages; it's just when you get this problem.

The final theory is basically the idea of a put option or negative equity with respect to homes. Basically, the idea here is that consumers can think of the option of default and foreclosure as a put option. If the house goes down in value such that it's worth less than the mortgage, consumers have the option of either continuing to pay the mortgage or giving it back to the bank. Now, what we know is that the places that have seen the highest foreclosure rates are also the places that have seen the largest drop in home ***269** prices, so that basically the rise in foreclosures has matched the timing of the fall in home prices. So what we have is people basically calculating, “is it worth it to me to continue paying the loan when I'm $100,000 underwater, or do I walk away?”

Now, what we also know is that the value of that option is affected by either the cost or the benefit of exercising the option; for instance, a major reason why California and Arizona are huge outliers in foreclosure rates is because they have non-recourse laws. Anti-deficiency laws mean that the bank can only take the house back and can't sue for a deficiency. What we know is we've got a lot of empirical evidence that says that lenders foreclose at three or four times—at triple or quadruple—the foreclosure rate when house prices go down. Which raises a question, in my mind at least, which is, if the problem is California and Arizona's absurd laws involving debtor collection laws, why is it my problem? Why is it Washington's problem instead of Sacramento's problem? That is a threshold question I have. Why are we bribing people? Basically, what we're saying is that the only way we're going to persuade people into not walking away from their homes is by bribing them. That's a weird sort of problem.

So anyway, we've got these three problems, the adjustable-rate mortgages, the walk-away problem, and the put option. Obviously—a dovetail—we've got things tied up together, but it just shows the complexity of this problem and the possibility for unintended consequences that might arise from it.

Thanks.

[Applause]

ALEX J. POLLOCK: Ladies and gentlemen, the bubble was huge, and as we all know, we're mired in a terrific bust. All kinds of asset prices plummeting, famous financial firms failing, credit contracting, and bailouts bloating the government's balance sheet. In sum, we're in an extended financial panic. As described by David Ricardo over two centuries ago, “On extraordinary occasions, a general panic may seize the country when everyone becomes desirous of possessing himself of the precious metals.” We don't do that anymore; now it's cash and Treasury bills. Ricardo continues, “against such panic, banks have no security on any system.”

We all know that no bank, even the most solvent bank, can survive a run, and a financial system made up of leveraged financial firms can equally not survive a run. This lack of security for leveraged financial firms against a generalized panic “on any system,” as Ricardo says, is what triggers government intervention, of various kinds, including government deposit guarantees (so-called insurance) and bailouts.

The bubble, while it's on, is characterized by greatly increased debt and leverage. A period of success leads to the belief by all parties— ***270** financial actors, regulators, politicians, theorists, competitors—that greater leverage and especially the use of short-term debt is safe. Of course, it turns out in the end that pushed to an extreme, it isn't. When the bust comes, everybody tries to “delever,” as we say these days, which means to reduce debt and reduce the ratio of debt to leverage.

Ask yourself this question: how is it possible for everybody to delever, for all balance sheets to shrink at the same time? Imagine that the entire financial system is one big balance sheet, and ask yourself: how can that aggregate balance sheet shrink? You will come to the conclusion that it can't, at least, it can't without an asset price collapse and widespread debt deflation.

So, if the need of private balance sheets to shrink is to be confirmed, some other balance sheet has to expand. That's the government's balance sheet. This yin and yang between these two balance sheets, the private balance sheet delevering in a panic and the government balance sheet expending in a panic, is what we observe. This is why the Federal Reserve balance sheets, if we add all the Federal Reserve banks together, have increased from about $860 billion to over $2 trillion. That's why we have the Troubled Assets Relief Program (TARP) program and all these other interventions. That's why we have, in particular, one bailout I want to mention, which is the bailout of Fannie Mae and Freddie Mac. This is of course not an intervention in the private sector but an intervention to save a government intervention.

[Audience laughter]

Fannie Mae and Freddie Mac were interventions of 1938 and 1970, respectively, which didn't go away.

We should hope that these other interventions will be temporary and reversed in time because every intervention brings with it expanded government and—in particular—bureaucratic power. My favorite example of an intervention which did go away was the Homeowners Loan Corporation of the 1930s (whose authorizing legislation, by the way, which took three and one half pages of statutory text—I give that to all of you as a good example). The Act required that the directors shall proceed to liquidate the corporation when its purposes have been achieved. Unlike Fannie Mae and Freddie Mac, this is exactly what happened.

A second thing to be hoped for in these interventions is that the taxpayers, who are being made into involuntary investors in the equity of financial firms and in distressed debt, will be thought of and treated like investors to the greatest extent possible. I even have the notion that if the various bailout schemes, like the TARP, succeed in making a profit, which in my view they very well may, 100% of that profit should be returned to those citizens who actually do pay federal income taxes as a dividend.

***271** [Audience applause]

As the last word, "Men's spirits are lifted when the times are prosperous, rich, and happy so that their pride and arrogance grow. Adversity chastens them and teaches them what should be done, but good fortune, which leads them to rejoice, usually makes them stray from right councils and clear thinking." That was true when Cato the Elder wrote it in the second century B.C., and it's true of bubbles and busts today.

Thank you.

[Audience applause]

ANDREW REDLEAF: This is a somewhat unusual circumstance for me. Normally, when I'm in a roomful of lawyers, half of them want me to shut up and be very guarded in what I say, and the other half want me to be loose lipped.

Everything the panel has said so far on housing, I basically agree with, and I think it's true—except for Bert's comment on credit default swaps—but it's all ancient history. It was last year's problem. It's still a problem, but we had a housing problem, and now we have a full-fledged financial crisis that began in September of 2008 pretty much with the failure of Lehman Brothers Holdings, Inc. (Lehman).

If you look at a graph or any other measure of financial conditions at the beginning of September 2008, we were bouncing along under the tightest financial conditions in modern history. Conditions may or may not have been tighter than in 1998, in the center of the long-term capital crisis, but they were tighter than in September 2001 after 9/11, tighter than in 2002 after the Enron-WorldCom Telecom bust, and tighter than in 1987 with that crash. Lehman was allowed to fail, and both business and consumer credit completely seized and dried up. Currently, less than 100 enterprises in America can seamlessly refinance their debt. The market price for everybody else is over 20%, probably 35%, pay level. You know, with that, no enterprise can pay and nobody can lend with the expectation of being paid back.

So, AAA commercial-backed mortgages are traded at over 20%, which means that the right cap rate for every commercial building in America is about 24%, 25%, or 26%, which is up in cap rate and down in value from about 7%. Every single building in America is underwater at fair market prices and—if this situation persists—every single building in America will change title from its current owners to some group of creditors. There's a massive sort of credit deflation going on, and that's the problem; it's no longer housing.

Allowing Lehman to fail is, I think by consensus, viewed as a terrible mistake, but it wasn't really something that happened in isolation. The Bear Sterns Companies, Inc. (Bear Sterns) and insurance companies came ***272** upon problems in March. Maybe there was a classic "run on the bank" or maybe a solvency issue; who knows? What is known is that the Treasury Department really wanted the Bear Stearns transaction done at $2 per share instead of $10 per share because somebody had to be punished. Shareholders had to reap their just desserts in order to assuage the gods of moral hazard. Far be it that all the employees lose 92% of their total net worth, much less 98%, 99%, or 100%.

The government then told everybody that Bear Sterns had a book value of $89 the day the deal was sealed, or that they had failed. That number was certified and supported by the officers of the company under Sarbanes-Oxley but also actively or passively by the Securities and Exchange Commission (SEC) and any one of a number of regulators, none of whom have been called to account for it. But shareholders have to be punished. So, although $2 would have been better than $10, we did $10.

Now, the government tells private markets to recapitalize and raise money. The problem isn't that severe. In Bear Stern's case, there are only $30 billion worth of assets—7%, 8%, or 10% of their balance sheet—that are questionable that we don't really know. The government will take that and might make money on them. [The government said to] recapitalized the system, and the private market responded, buying $400 million of preferred stock from financial institutions. That stock had to really be preferred because companies didn't need more debt. Also, we know that equity was wiped out, so the private market came up with the only solution: something in between.

Fannie Mae and Freddie Mac were nationalized, and as a matter of policy choice, that $400 billion to financial institutions was wiped out. This was required to assuage the gods of moral hazard. A week later, Lehman failed and not only preferred shareholders but also bondholders and counterparties were punished because that's what moral hazard required. The government took an about-face a week later when American International Group (AIG) warned of failure because, if AIG had been allowed to fail, Merrill, Morgan Stanley, and most importantly, Goldman Sachs, surely would have failed as well, which was too much.

AIG was first rescued very punitively before the government changed its policy, using the TARP and the preferred stock offered to financial institutions. But the objective of these policies was still to punish the bad people. To those on the political left, a bailout of the auto industry, for example, couldn't be done because the executives had to be punished. The executives came to Washington in three separate private jets and wasted $60,000. If you favor the political right, the auto industry couldn't be bailed out because that would be comparable to Obama's support of the unions.

The gods of moral hazard, I would submit, have been assuaged enough. We now actually have to stop worrying about making micro-mistakes, picking winners and losers in the overall, winners and losers ***273** among sort of specific companies, and we have to stop what is a massive credit deflation. Inflation and deflation are government policies and not a matter of the free markets. We have to get beyond blame and prevent the irregular transfer of every asset in the country from current holders to debt holders.

[Applause]

HONORABLE DOUGLAS H. GINSBURG: Well, there is a lot on the table. Shortly we are going to open this to your questions. Before we do that, I do want to allow a little bit of cross talk. Again, some of you may recall—this was on Saturday Night Live during the early ‘80s when we had a run of problems—a skit involving the representatives of labor, industry, agriculture, government, and so on, playing a panel game called “Pass the Buck.” Each one had one minute to explain why it was the next one's problem.

We have had two different perspectives, actually one favorable perspective on the CRA, and at least one, maybe two, negative ones. I will let that issue be joined by itself. You do not need a provocateur for that, although I am interested in John Taylor's attempt to explain a variable by reference to a constant, namely greed.

[Audience laughter]

Putting that aside, the panel has focused primarily on causes, which I think has been a very useful exercise, and less on prescriptions, leaving us time for that.

Peter Wallison, you predicted this in 2004 and 2005. I reread your articles recently, predicting it with a level of precision that makes you a rather frightening person to be around.

[Audience laughter]

So my question to you is, to get us started on the next phase, what should we do in view of this? Your point was to examine the causes carefully so that the response is tailored to that. We have some difference of views on causes, but actually a lot of convergence as well. What are you going to tell us about the prescription? In particular, we have seen the government make more proposals than executions and adopt several different responses in the space of a mere couple of months. There is some suggestion that that vacillation is itself aggravating the situation. But putting aside the problem of inconstancy, what should we be doing?

We will go right down the line, one or two minutes each, and then turn it over to what I hope will be a patient bunch of lions waiting in the coliseum here.

***274** PETER J. WALLISON: Thanks very much. I guess I set this up myself, didn't I?

Obviously, there are short-term and long-term solutions we want to deal with here. Right now the situation that we're in, I believe, can only be resolved if we take care of the mortgage problem at its base. I do believe that there will be many, many more failures, and as long as those mortgages and mortgage-backed securities are on the balance sheets of banks, we will have a weak and timid banking system. It will be very hard to get loans from banks. It will be very hard to have our economy grow, and we may end up having to continuously recapitalize banks.

I happen to be a believer in the original idea of the TARP program. I thought that the right thing to do was to buy the assets from the banks because if the assets continue to weaken after you bought them it's for the account of the government rather than the account of the banks. As long as they are weakening within the banks, we are just going to have to keep feeding capital to those institutions. That is the wrong policy, and one that has almost an endless series of losses associated with it.

So, we need a standardized program, as I see it, to address the mortgage problem. We can't do it one at a time. We can't do it by applying new bankruptcy law provisions to mortgages; we have millions of them out there that are going to be problematic. We need a standardized program that will reform and refinance the mortgages that are weak and get those mortgages under control. Once that happens and once there is a floor under the housing market, I think we will start to see a recovery.

Now, the long-term prospect is much, much more difficult in my mind because it gets into questions of housing policy and the things I addressed in my initial remarks. But one of the key questions here is how much the government is going to be involved in encouraging the expansion of homeownership in the United States. As I said, we have been spending, from my perspective, a lot of money on this. It's a worthwhile thing to do—to expand homeownership. But if it's to be done, it should be done through a government program that is based on taxpayer funding like most others, above board, with the ability to criticize it and the risks that are taken and should be taken by the government currently. What we have done in the past, through Fannie Mae and Freddie Mac and—I think also—through CRA, was place those risks on the banking system or on Fannie Mae and Freddie Mac which ultimately created the problems that we have today. So, if we're to do it, we should do it through some sort of subsidized down payment program.

HONORABLE DOUGLAS H. GINSBURG: Let's get CRA straightened out. It is true, is it not, that CRA is applicable only to financial institutions with deposit insurance?

***275** PETER J. WALLISON: Yes.

HONORABLE DOUGLAS H. GINSBURG: I think we were told that they are therefore subject to safety and soundness regulations, the originators, right?

PANELISTS: Right.

HONORABLE DOUGLAS H. GINSBURG: So the loans that are originated by independent mortgage brokers are not subject to CRA?

PANELISTS: Right.

HONORABLE DOUGLAS H. GINSBURG: So is CRA really a part of the problem here?

PETER J. WALLISON: Yes. I think the fact that they are regulated and that banks are required to make loans that are safe and sound doesn't mean the loans are actually safe and sound. In fact, the regulations that the Clinton Administration adopted in 1993 essentially said to the banks, “You shall make these loans, and you shall make them under the penalties prescribed, and if the loans are not good loans, they ought to at least be flexible, and we'll deal with the problems in the future.” But the loans were not all good loans.

HONORABLE DOUGLAS H. GINSBURG: John Taylor.

JOHN TAYLOR: AEI wants to keep this CRA discussion in front of things because they don't want to focus on the malfeasance of the industry. Let's face it; it's the private sector that brought us here, the unregulated institutions, the people most of whom have gone under because of this malfeasance. But CRA actually performed at or better than most market and most non-CRA regulated .

PETER J. WALLISON: Let me just put it to the audience this way. If those loans were going to be profitable loans for banks, you didn't need CRA.

JOHN TAYLOR: No, that's not true because what happens is it's easier for a bank to make a loan—I'll use a business example—to a corporation that is looking for $10 million than if they have ten small businesses come in each one wanting $1 million. It is, in fact, a more profitable enterprise to do the higher-end loan. But the law simply requires that you cannot ignore creditworthy people who have the ability to pay their mortgage just because they're lower on the economic spectrum. That's all it requires.

***276** BERT ELY: On the CRA issue, I actually addressed this on this panel a few years ago when I was here, and I looked at the legislative history when the CRA was enacted. The CRA was premised on the idea that most bankers are dumb bigots. There is no data developed to support that because non-bigoted people are not going to discriminate against minorities, women, and what have you is smart bigots who are going to lend to anybody, despite what their personal preferences are.

What also concerns me about CRA is that it's part of a broader public policy emphasis of overstressing homeownership, and I think that overstressing homeownership is what we have to back away from. We must stop sanctifying it quite as much as we have in the past, while at the same time asking homeowners to have more skin in the game so that they are, in fact, a genuine homeowner and not a renter disguised as a homeowner.

JOHN TAYLOR: I'd like to explode that myth too. By the way, I want to point out that it takes six conservatives and libertarians to deal with one liberal.

[Audience laughter]

First up, on the issue of homeownership, you should know that these high-cost loans, these predatory loans, these loans that are toxic that have caused this market meltdown have very little to do with new homeownership. In fact, less than 10% of the loans that were made in that period of time—2003 through 2007 when the worst of the loans occurred—had nothing to do with helping, or Clinton's initiatives, or anyone's initiatives pushing people to homeownership.

It had to do with existing homeowners getting bigger homes, refinancing, home-equity lines of credit, taking the equity out and using it for consumer spending, and the willingness of the private-sector financial institutions, in particular mortgage companies, to be willing to put the cash on the table repeatedly and offer them more than they're asking for. That's what that was about.

HONORABLE DOUGLAS H. GINSBURG: Do you have any data on loan problems with mortgages originating from supervised institutions versus others?

PROFESSOR TODD J. ZYWICKI: I've not seen data on that particular topic.

HONORABLE DOUGLAS H. GINSBURG: All right. We will take a brief interlude for a door prize. Does anyone know what a Ninja loan is?

***277** [Various responses]

No income, no job or assets. Very good. You would think that we had a null set, but it is not a null set.

[Audience laughter]

We will take our first question from the audience.

AUDIENCE PARTICIPANT: I'd like the panel to focus more on structural and procedural reforms that could deal with the larger problem in the long term. What we seem to have is not just a mortgage bubble, but a standard of living bubble, a super bubble as it were, like the ones that we saw in the tech bubble and even going back to the savings and loan crisis of the ‘80s. I've watched it through my life, and I've observed certain fundamental, underlying causes.

Milton Friedman once said that he was in favor of free markets but not of large organizations. Alan Greenspan seemed to have been shocked by the discovery that decision-makers in this field are not unitary decision-makers. They are aggregates of individuals, echelons, departments, and interdependent, co-dependent networks that often operate in conflict with one another. This is the so-called “agency” problem. I've observed, especially in larger organizations, how management can decide to act for its own benefit in ways that are contrary to the interests of the shareholders.

So what I would like to propose for your consideration is to revive the traditional grand jury system to engage in freewheeling investigations of any organization or network of organizations that is too big to fail, or too well connected to fail, that would not be so much trying to decide if they satisfied certain cut and dry accounting standards, in accordance with Sarbanes-Oxley. But this would be free to inquiry among anyone who might know, including the lower-level employees or with any business partners, if there are any problems they can foresee due to conflicts of interest. Then, bring the organizations forward so they can be exposed to everybody who is concerned.

HONORABLE DOUGLAS H. GINSBURG: All right. Let me ask if there's anyone who wants to comment.

PANELIST: Could you repeat the question?

[Audience laughter]

HONORABLE DOUGLAS H. GINSBURG: Todd.

***278** PROFESSOR TODD J. ZYWICKI: I'll just say one thing. One of the things that bugs me about the way this has played out is that it's played out against the backdrop of the election season. I think one of the things that happened is that everybody is just running around looking for scapegoats and partial stories.

Lenders defrauded borrowers. Borrowers defrauded lenders. Wall Street screwed up. Government policies were bad. Monetary policy was bad. I mean this was a perfect storm of people screwing things up. I think some theories are more plausible than the others, but I think the big thing is trying to get in and look at all the various things that were going on. It's not just a matter of poor hapless borrowers getting screwed by lenders, or lenders getting screwed by borrowers, or all these different sorts of things. There were lots of things that came together here, and I think that if any of the bits and pieces had not gone as bad as they had, then this would not have been quite as bad as it is.

I do think one big issue—and John Taylor and some of the other panelists referred to it—is that the rating agencies do in fact play an unusually pivotal, nasty part in this. The rating agencies—you know, Moody's, Standard & Fitch & Poor's—who were willing to slap AAA ratings on this and allow this stuff to kind of get out of its cage such that people say a condominium gets foreclosed in Florida and Iceland's economy fails. I think that's the piece that turns it from a disaster to a catastrophe, if there's any piece.

HONORABLE DOUGLAS H. GINSBURG: One second. Bert Ely is up.

BERT ELY: I think we also have to realize that not only are there multiple causes and interconnected causes but also a lot of the roots of this go back many decades. The more I look at it, for instance, I see the 1986 Tax Act and its restriction on interest deduction to only interest on home mortgages as an underlying cause because after that point in time we saw a tremendous increase in indebtedness on homes. Also, perhaps only coincidentally, from 1986 until the present, the U.S. went from a slight creditor nation to the rest of the world to being in hock on a net basis to the rest of the world to the tune of about $2.5 trillion, which gets back to consumers' negative savings rate and the use of their homes as ATMs.

We have to drill way deep down and go way back in time to see the causes that changed the incentives that have gotten us to the point where we are, and that created the environment for the perfect storm.

HONORABLE DOUGLAS H. GINSBURG: Alex, briefly.

ALEX J. POLLOCK: On the metaphor of the "perfect storm," I was at a meeting the other day where that term was used and people kept referring ***279** to the hundred-year storm. My comment was that the problem with hundred-year storms in financial systems is that they happen every twenty years.

[Audience laughter]

HONORABLE DOUGLAS H. GINSBURG: From the audience.

AUDIENCE PARTICIPANT: I've heard two points that do not seem to square with each other. In John Taylor's case, apparently he tells us, and to my relief, that this is really an upper-middle class problem and that all the minority and low-income loans are fine under CRA. So, at least we are not going to have a class or race dimension to this argument. I think what he really needs to say is that all the evil mortgage-backed securities that were lent so low to minorities did not serve them but took advantage of them, which just goes to the question of whether those loans should have been made at all, which at least Barney Frank admitted last week.

JOHN TAYLOR: The CRA loans are fine. It's the non-CRA loans to minorities. Just to be clear.

AUDIENCE PARTICIPANT: I believe, John, that what you said was that those other loans—or it may have been another panelist—were not made in service of those communities. So either one would have to logically say that they were not made to low-income and minority people, or that these were loans made to those communities whose people could not qualify for CRA loans, or there is no minority or low-income dimension here.

JOHN TAYLOR: The majority of loans, by the way, that we're talking about that are now toxic and having problems are to white people and to middle-income people.

HONORABLE DOUGLAS H. GINSBURG: That is not highly surprising, but the question is whether it is disproportionate.

JOHN TAYLOR: Yes, it is disproportionate. I'd say it is disproportionate that communities were targeted by the subprime, non-CRA lenders. So it's disproportionate compared to their percentage of the population.

HONORABLE DOUGLAS H. GINSBURG: In minority communities?

JOHN TAYLOR: By minority communities. Yes.

***280** AUDIENCE PARTICIPANT: Peter Wallison, I wanted to take you on because you say, much as Sheila Bair actually, that it would be far too complicated to handle this all through bankruptcy and instead it has to be handled through a bureaucratic mechanism of the government buying all these securities and deciding how to readjust them. That, to me, simply seems to be a kind of bureaucratic burden shifting. It seems to me that bankruptcy is exactly the existing non ex post facto way that is constitutionally considered to address these problems.

So, I propose that we take a more small claims court approach to bankruptcy, and we accept that we have a system for dealing with this. Let government set the forum and not the solution.

HONORABLE DOUGLAS H. GINSBURG: Let me point out, this is the first person to have used the "B" word [bankruptcy]. Peter.

PETER J. WALLISON: I understand the argument about bankruptcy. I just do not believe that with millions of mortgages in trouble you can handle it through the court system. The court system is already clogged and putting it into the bankruptcy courts or bankruptcy masters throughout the country would take much too much time to straighten out the serious problems we have in the banking system. That's my principal problem there.

ANDREW REDLEAF: I think, at a macro level, there is a saying, "all debt is repaid either by the borrower or the lender." What actually has to happen is the private sector has to delever. Corporate-wise, that will happen pretty quickly. Consumer-wise, it's much harder. Deflation is immoral. It allows people to get rich by avoiding commerce. We need to have 5%, 6%, 7%, 8% inflation for four or five years, which will delever the consumer by 40% or 50%, with the Federal Reserve watching very carefully net credit creation, and that outstanding credit should not be allowed to rise during that period so that the consumer can delever. In one manner or another, loans are going to be repaid by some mix between the borrower and the lender. A little targeted inflation for the next few years is, I think, the best sort of solution.

HONORABLE DOUGLAS H. GINSBURG: One-minute history lesson. In the 1870s, in the panic of 1873—I think it was—the railroads, which had been recently built and highly leveraged, built into the West and were almost uniformly in default and bankruptcy. The similarity with the current situation is not great, but it has this in common: it was absolutely essential that the railroads continued to run because the crops had to come in or they would spoil in the field. The people in the East who consumed and the people in the West who produced were totally interdependent and linked by those railroads. The bankruptcy courts did step in. They invented something called receivers' certificates. They appointed receivers ***281** who issued debt that was senior to all of the debt on the books, and they were reasonably successful in taking these huge reorganizations through a period of years.

This is not the same situation. Whether bankruptcy courts would be up to it now, I do not know. It is so international, there are so many players. But it is not the first time this kind of a challenge has arisen.

PROFESSOR TODD J. ZYWICKI: The big bankruptcy issue that's going on right now is whether or not bankruptcy judges will be allowed to strip down mortgages in bankruptcy. Basically, if your house is worth less than is owed under current law —and it's always been the law—and you want to keep your house, you have to pay the note as written. You can't write down the value of the mortgage to the value of the property. One of the proposals on the table is to allow them to do that as well as allowing judges to adjust the interest rate. That's what Peter Wallison was referring to.

Now, I think a couple of things are interesting about this. First, it would be a dramatic change in law that's never been allowed. Second, there's no such thing as a free lunch. Obviously, that's going to increase the risk of lending, and it's going to increase interest rates going forward for future borrowers, especially for those who are most likely to file bankruptcy.

Third, there's a question about the extent to which that is needed because—for various reasons I will not go into—it turns out that there's an ability to already strip off home equity loans that are completely underwater which I think takes care of some of the problems and—at least with some of the houses—does not require any change in the law.

Interestingly enough, for some reason we do not understand, homeowners who have the same loan-to-value (LTV), which is the amount they owe versus the total appraised value of the property, are more likely to default if they've got a home equity loan that has the same LTV than on just a purchase money loan.

But the final point on cram down is my concern that, with respect to Congress, it looks like something free. One of the problems we've created with the bailout is we've painted ourselves in a corner because it's so darn expensive and only moderately effective at best, and it forecloses other options because we've got less money to do other options.

So, my concern is that Congress is now looking around for less systematic systems for trying to do things that it does not have to pay for, and it's looking at cram down as one of these options. I'm not convinced it's a good option. Why? Because, number one, it only addresses some loans. Number two, I think it's going to create real incentives for people to file bankruptcy because it's going to allow them to strip down loans and then keep the value when it goes up on the back end. Third, it's going to drag in ***282** a lot of non-mortgage debt along with it, such as credit card debt and car loans. All those sorts of things are going to get dragged in.

If it's a mortgage problem, come up with a mortgage solution; do not come up with a bankruptcy solution to a mortgage problem. I think this is a real Pandora's Box that they're potentially opening if they allow cram down of home mortgages.

HONORABLE DOUGLAS H. GINSBURG: Okay, we are going to take a very brief comment from Bert, then back to the floor for the next person who will bring in a new subject.

[Audience laughter]

BERT ELY: We have to realize two things. First of all, the Federal Reserve cannot create inflation. That I think is a pipe dream. The second thing is that home prices are still not at the bottom. This is the experience of the ‘80s down in the Southwest. We have to let home prices hit a floor, and then we need ownership of homes to shift into the hands of those who are willing owners of these homes. Frankly, there are a lot of people in homes that face foreclosure that frankly would be better off personally if they were out of the home, didn't own it any longer, and I'm not sure we're doing them any great service by trying to keep them in a home that they would be just as soon be better off not owning. So, we need to have the market clear, and then we will start to see the recovery in housing prices.

HONORABLE DOUGLAS H. GINSBURG: Thank you. Next topic.

AUDIENCE PARTICIPANT: I do, in fact, have a new topic: the incredibly destructive effect that fair-value accounting has had on the financial system. It just seems incredible that we're in month sixteen of the crisis and the SEC still has a task force looking at that. About a month and a half ago, we got clarifications that dealt with the worst aspects of fair value mark-to-market accounting, but of course, they are discretionary and have come sixteen months too late. Once the toothpaste is out of the tube, it's hard to imagine anyone having the nerve to take the litigation risk of writing assets back up.

But, now that we've discovered this was a colossal mistake, I guess the question is what are we to do going forward because it seems like it's been enormously destructive to the system.

ANDREW REDLEAF: I really disagree with the questioner. I think one serious aspect of the problem was a year ago, and I wrote about it. Merrill and other financial institutions were lying. At that point, they were solvent. I believe they were solvent. If they had sort of told the truth, they could've raised capital and gone on as ongoing concerns. It was the opacity ***283** and dishonesty that majorly confounded the problem. I think there are two different points.

There are two standard definitions of solvency. One is your ability to pay bills as they come due, which should be the sort of operant definition that we use. Under their definition, certainly when they had access to the Treasury, Fannie and Freddie were solvent, and they actually had incredibly valuable businesses. The other definition of solvency is the value of your assets exceeding your liabilities, and in terms of handling institutions and pressures, we want to use the first definition of solvency and not the second, but we do want to actually know what the fair value of everybody's balance sheet is.

HONORABLE DOUGLAS H. GINSBURG: Peter.

PETER J. WALLISON: I agree with the comment that was made by the questioner. Fair-value accounting has, I think, been very destructive simply because there has not been an active market on which to base the mark-to-market judgments that are made. But I would mention one thing, Citibank announced that it was going to use the SEC clarification that was made on September 30, 2008, which I think was actually a reversal by the SEC, and that it was going to move many of its assets into held-to-maturity accounts and from trading into held for sale, which is the second category.

HONORABLE DOUGLAS H. GINSBURG: So it doesn't have to mark them down to current market.

PETER J. WALLISON: No, it doesn't have to mark them down to current market as it would with trading assets and it would also, to some extent, with its assets in the held-for-sale category.

In addition, and this is even more important, the International Accounting Standards Board (IASB)—they're the equivalent for Europe of Generally Accepted Accounting Principles (GAAP) and the Financial Accounting Standards Board (FASB) in the United States—allowed banks to do that sometime in early September 2008. In fact, in its financial statements after September 30, 2008, Deutsche Bank moved many of its assets into the held to maturity category, and its stock price rose 18% when it did. In other words, investors will understand the way assets have been marked, that they are marked excessively down because of this mark-to-market idea, and they will not rebel against it and say this is lying or this is management and manipulation.

HONORABLE DOUGLAS H. GINSBURG: Well, let me ask you this, Peter. Since the value of the asset and the asset itself do not change regardless of the accounting, is it that investors are somehow mesmerized ***284** by the accounting or is it that the change in accounting is more assurance against government intervention?

PETER J. WALLISON: I don't know that it's the latter. We don't know what the assets are worth, and if you're going to look at one index, which is the market price, that could be a misleading index. The best index for determining what assets are worth is what their cash flows are.

HONORABLE DOUGLAS H. GINSBURG: Sure.

PETER J. WALLISON: Someone has to go in and look at the cash flows and value the assets based on discounting those cash flows. That's not what we have been doing. We've been expecting investors in the market who know nothing about the cash flows in these particular assets and are scared to death about what is in these portfolios to make a judgment about what these things are worth.

HONORABLE DOUGLAS H. GINSBURG: But they do not know any more when the bank switches the accounting, right?

PETER J. WALLISON: I think the only way you can interpret what happened with Deutsche Bank is that the market—the investors actually—did think that the assets had been written down too far. We don't know which ones or how many, but they did think it was true. When it was possible for Deutsche Bank to move some of these into a different category where they wouldn't be judged by market prices, the bank looked healthier and investors gave them credit for that.

HONORABLE DOUGLAS H. GINSBURG: I'm still mystified. If the bank seems to be undervaluing its assets, that looks like an investment opportunity to me unless it might be a trigger for the government to liquidate the bank.

PETER J. WALLISON: It could be, in fact, an investment opportunity for people, and people have hoped for that. But as long as you follow mark-to-market accounting, the assets are going to continue to decline in value in the market because the sales that are going on are by and large liquidation sales. These are sales where people are forced to sell or distress sales without any buyers. The people who are picking them up are vultures at very low levels. So, there is a downward spiral.

BERT ELY: One of the key reasons we have this is due to maturity mismatching of assets that are funded with relatively short-term liabilities. If an institution feels the market is just being too harsh in its valuation, then what it should do in the interest of its stockholders is to hang onto those ***285** assets and ride through the price depression. In order to do that, however, it has to have liquidity in place. So, it's not just a matter of shifting assets from available-for-sale to hold-to-maturity but also of having the financing in place to be able to hold them to maturity.

What I hope comes out of the financial regulation and accounting revisions that are going to take place is a greater recognition of the need to reduce maturity mismatching. This will reduce a lot of these accounting problems.

HONORABLE DOUGLAS H. GINSBURG: Andrew, briefly, and then back to the floor.

ANDREW REDLEAF: I think the argument that there is no market is very often used as a crutch. There is a bid for every asset in the world. There is a price at which you can sell everything. It really comes down to, again, the second definition of insolvency. I think people are entitled to know what the fair market value is, what the bid is, what the offer is. However, if an entity can meet its bills—which is sort of a cash flow number—we don't want assets being seized and the dead weight loss of transfer that incurs. The idea is to not seize assets from people that are insolvent on a fair market value but can pay their bills.

HONORABLE DOUGLAS H. GINSBURG: Thank you.

AUDIENCE PARTICIPANT: I was just wondering what the panel thought should be done to fix the incentives and competence of the "rating agency triopoly."

HONORABLE DOUGLAS H. GINSBURG: The "rating agency triopoly," okay.

ALEX J. POLLOCK: This is an important topic. I wouldn't call it a "triopoly." Many people say "shared monopoly." Since you typically need two ratings, there is no competition. The rating agencies are clearly a central point in the whole unfortunate story of the bubble. The reason they are is a set of government actions by the SEC and the many other regulators that enshrined ratings from particularly designated rating agencies as regulatory requirements. These were even put into the so-called Basel II capital rules.

This set of regulations created a concentrated point of failure. In thinking about the design of any system, you may wish to avoid concentrated points of failure. The rating agencies became exactly such a point in the mortgage market.

Many people have pointed out that a rating agency that works for investors should have a better incentive structure than a rating agency that ***286** works for the issuers of securities. I think it's a fair point. I think we ought to create and encourage, in every way we can, rating agencies that are paid solely by and owe their duty solely to the buyers of securities as opposed to the sellers of securities.

HONORABLE DOUGLAS H. GINSBURG: Sounds like a business opportunity also.

AUDIENCE PARTICIPANT: Wouldn't that create a free rider problem?

ALEX J. POLLOCK: I didn't say that you have to give your ratings to everybody, just people who pay for them.

AUDIENCE PARTICIPANT: All right.

HONORABLE DOUGLAS H. GINSBURG: John Taylor.

JOHN TAYLOR: I was actually going to make that last point that Alex made but also say that I think we have to find a way for these agencies to have a due diligence standard. In meeting with them and talking with them about this, I invariably get to a conversation where they sit back, and they say we're not a due diligence agency, and I always say: “Really?” “Did you know that most people think you are?” You see the AAA rating—or whatever the rating is—and you assume that what's happened is they've verified the information they've received from the people who are paying them. But they don't. They go on the face value of what they receive, and they are emphatic about not doing due diligence. I think that has to change.

HONORABLE DOUGLAS H. GINSBURG: Bert, go ahead.

BERT ELY: To go back to a point I made during my opening remarks, they have a First Amendment protection which effectively protects them against negligence. When they are paid by the issuer, they become part of the underwriting process. I would suggest to you that if the rating agencies could be sued for negligence when they have been paid by the issuer they would be much more conservative with the ratings they give out. I don't think they would even bother to rate, or try to rate, these very complex securities that are very much part of the problem.

Again, why should they be exempt, in a way that the Certified Public Accountant firms are not, when they give opinions on financial statements where they've been paid by the issuer of the financial statements?

HONORABLE DOUGLAS H. GINSBURG: Peter.

***287** PETER J. WALLISON: I'm really troubled by the free rider problem that you mentioned. If a seller pays the rating agency, that's obviously a problem. But if the buyer pays the agency, anyone else can come in and buy the same securities without paying. So, there is a disincentive on the part of the buyer to hire a rating agency because that buyer is paying for everyone else. It's a very tough problem, and I've never been able to come to a satisfactory solution.

The only thing that seems to make sense to me is to require the rating agency to acquire some of the assets, some of the securities that are being sold, and hold those securities.

[Audience laughter]

HONORABLE DOUGLAS H. GINSBURG: Well, Peter, Alex's response was that they didn't have to publish what they rated.

PETER J. WALLISON: If you know someone's buying, then you know that there is probably a rating behind it. Those things leak out in any event. I agree with Alex from that point of view, but it is very hard to keep that kind of information confidential.

PROFESSOR TODD J. ZYWICKI: I just want to add, in a lot of this, simple error should not be left out of the equation. I think a lot of people on Wall Street did bad things, but I also think a lot of them just made mistakes. For instance, they extrapolated from a long history of how houses behaved in the prime markets to a whole set of new borrowers in the subprime market. To some extent, they may have just had bad models that they were dealing with that people are going to learn from. We need to divide out bad incentives from mistakes in thinking about these questions.

ALEX J. POLLOCK: "Error is more formidable than fraud. The losses to which a plausible manager in complete good faith would commit a bank are beyond comparison greater than those which the dishonest manager would strive to conceal." Walter Bagehot, 1873.

HONORABLE DOUGLAS H. GINSBURG: That was the same year, 1873.

[Audience laughter]

Okay, we're narrowing the focus now. Last question from the floor.

AUDIENCE PARTICIPANT: As far as the prescription goes, Peter Wallison has come out recommending acquiring troubled assets. I'd like ***288** the remainder of the panel to comment on the desirability of that approach versus the approach that has been followed so far, which is injecting capital into selected trouble institutions. In that context, if you could also comment on the objection voiced by some that many of these so-called toxic mortgages have been sliced and diced and securitized and pooled to an extent that makes it infeasible to reacquire them.

HONORABLE DOUGLAS H. GINSBURG: John.

JOHN TAYLOR: Thank you for asking that question because, for me, one the most significant things that's been said here today is something that Peter said, and it also gives me an unusual opportunity to agree with something different from what AEI has said.

If AEI, NCRC, and a whole bunch of other folks are saying we've got to stop the bleeding, we're looking at somewhere between five and seven million more toxic mortgages that, if we don't do something, we will continue to see it undermine Wall Street securities and our economy as a whole. So, the most immediate thing beyond all the other things we've been talking about is that we've got to come up with a solution. Unfortunately, the voluntary solution that has been offered, Hope for Homeowners, has done eighty-six loans in the first two months of its existence.

I don't know if I need to say that again, but the point is that even within the administration you can tell there's a lot of disagreement. God bless Sheila Bair because she's had the courage to stand up and say we really need to do something more substantive. Unfortunately, it looks like this thing is going to be punted to the next administration. That's going to be two more months of increased foreclosure filings. This past month, we had 240,000 mortgage foreclosure filings, and that's the thirty-fourth consecutive increase of the previous month from the previous year. In other words, nothing has slowed down the mortgage foreclosure crisis. It continues to grow. According to Paulsen and Bernanke, in the next year alone we are looking at between two and two and a half million more foreclosures. That's more than we've had already. There's no question that something inordinate needs to happen.

It seems to me there are two remedies immediately available: one is the reverse auction; the other is what's been proffered by Professor Johnson from Harvard, who suggested that we use the eminent domain statute to acquire these toxic mortgages. Perhaps we should pay something more than fair market value, whatever that is, to sweeten it for the investors and work with the servicing banks. We need to get them to understand that this is the best deal you're going to see in perhaps ninety years. But acquire those homes so we no longer have to sit there waiting for voluntary action, waiting for one investor to move while the other one sits there waiting for that investor to move because they think that will turn the market.

***289** We've got to grab these loans and get ahead, create the floor on this foreclosure crisis, and have meaningful modifications that keep working people able to pay on their loans. The new subset of folks that Alex Pollock identified are people who have not lost their job, are not divorced, are not in ill-health, who are still working at the same income, but whose homes are putting them underwater. Get those folks the kind of mortgages they should have had in the first place, and work with the industry, the private sector, and the government. The government can recoup whatever it puts into this over a period of time. If we don't do that on a grand scale, as Peter said, then we're going to continue to have this devastating pull-down on the economy that's going to hurt every other effort.

HONORABLE DOUGLAS H. GINSBURG: Did I hear a bell?

[Audience laughter]

Our time has run with three or four people on the panel who wanted to say something. We also had more questions from the audience. If someone doesn't throw us out of the room maybe you all can get together.

Please join me in thanking the panel.

[Applause]

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Footnotes

1 Scott M. Polakoff, Office of Thrift Supervision, U.S. Department of Treasury, served as a panelist in this discussion but did not wish to publish his remarks at this time.

5 JLEP 259