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A Review of Brookings Institution Discussion Paper: “The Great Credit Squeeze: How it Happened, How to Prevent Another”

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The Brookings Institution on May 16, 2008 published a discussion paper, “The Great Credit Squeeze: How it Happened, How to Prevent Another” (“Credit Squeeze”), concurrently with a public forum on the same subject.² Written by Robert E. Litan, Martin Neil Baily, and Douglas W. Elmendorf, all affiliated with Brookings, the paper weighs in at more than 160 pages. It is to be published in book form in November 2008.

To the extent that its title implies startling new insights or daring solutions to the problems confronting the financial sector, Credit Squeeze may disappoint some readers: I suspect that there is little here that will surprise expert observers of these matters (a category that does not include this reviewer). But the paper’s authors probably did not intend such an implication in any event. They readily acknowledge that their paper is a “work in progress,” a sensible caveat in view of the frequency and force of the shocks that continue to rock the financial system. The paper contains a wealth of information about the origins of the current turmoil in our financial markets, offering thoughtful conclusions, debunking a few misconceptions, and making some interesting proposals for reforms. Moreover, it is richly annotated with interesting graphics and references to academic studies and other materials. Many readers should find it useful – as I did – to have such a large amount of data and wide range of possible policy responses addressed in a single document.

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² In addition to the paper’s authors, other participants in the forum were FDIC Chairman Sheila Bair, who delivered opening remarks; FDIC Chief Economist Richard Brown; Keith Ernst, Senior Policy Counsel of the Center for Responsible Lending; and Sebastian Mallaby, Director of the Center for Goeconomic Studies and Senior Fellow for International Economics, Council on Foreign Relations, a *Washington Post* columnist. A transcript of the forum is available on the Brookings website.

Litan, Baily and Elmendorf bring impressive credentials to the task of analyzing the financial crisis. Litan has been a frequent speaker and writer on issues affecting financial institutions, including, among many other publications, “What Should Banks Do?”, published by Brookings in 1987, which considered the “narrow bank” and other proposals for balancing the benefits and risks of federal bank insurance and product diversification. He has been affiliated with Brookings for many years and also serves as vice president of Research and Policy at the Kauffman Foundation. Litan has a distinguished record of public service, having served on the staff of the Council of Economic Advisers (1977-79), as Deputy Assistant Attorney General in the Antitrust Division of the Justice Department (1993-95), and Associate Director of the Office and Management and Budget (1995-96).

Brookings Senior Fellow Martin Baily, an MIT-trained economist, has also served in Democratic administrations. He was the chairman of the Council of Economic Advisers during President Clinton’s second term (1999–2001) and served as one of the council’s three members from 1994 to 1996. Doug Elmendorf’s federal posts have included the serving on the Federal Reserve Board staff, U.S. Treasury Department, Council of Economic Advisors, and Congressional Budget Office, focuses his research on macroeconomics and fiscal policy.

Origins of the Crisis

The first of Credit Squeeze’s three main sections is devoted to The Origins of the Crisis. It consists largely of a review of the usually-cited culprits, including the widely held view that housing prices would always rise; a shift in the composition of mortgage lending from prime to subprime beginning in 2004; the erosion of underwriting standards in the “underwrite to distribute” model of mortgage origination, in which fraud and deception by mortgage originators and borrowers alike played an “important” but hard-to-quantify role; over-reliance on rating agencies, which failed to do their jobs properly due to conflicts of interest and faulty financial models; financial institutions’ failure to follow their own risk management policies; and continuing low interest rates, due largely to the abundance of foreign capital pouring into the United States. The authors note that, as of May 2008, \$260 billion of losses had been taken world-wide as a result of the mortgage problems. It is sobering that they cite studies projecting

total losses of more than twice that amount, in a range between \$565 billion and \$600 billion, although they allow that these predictions may be overly pessimistic.

Litan, Baily and Elmendorf deserve credit for providing a balanced analysis of the causes of the current crisis, yet their somewhat detached, academic tone also has a sort of leveling effect, conveying the impression at times that all the factors they describe had equal weight in bringing us to our current situation. In fact, I do not believe this to be the authors' view. They are very critical of the credit rating agencies, and their analysis of the agencies' role in bringing about the crisis is persuasive.

Another interesting portion of the discussion places a significant amount of the blame on regulatory failures – and in particular inaction by the Federal Reserve – with the honorable exception of late Federal Reserve Governor Edward M. Gramlich, whose prescient warnings of the dangers of declining lending standards were largely unheeded when there was still time to do something about them. In singling out the Fed, Credit Squeeze refers not to the central bank's low-interest rate policy following the 2001 recession, which the authors generally absolve of responsibility as a contributing factor, but rather its failure to use its considerable influence to head off the mortgage lending problems which were becoming apparent as early as 2005: “Despite the limitations of its authority, the Federal Reserve should have done much more to slow or stop the erosion of mortgage lending standards ... The Federal Reserve had the stature to change things and to influence state regulators. Appropriate warnings given privately or publicly could have significantly reduced the amount of bad lending even in markets where the Fed had no direct legal authority.”³

The authors raise the question why Federal and state regulators did not do more, and suggest that an indiscriminating belief that less regulation is always better, and that free markets can take care of any problem, played a part. (It seems to me that more might be said about the role of free market ideologues--including some prominent members of the regulatory community itself--in bringing our free market economy to its knees.) But the authors make clear that they are not against *all* deregulation, just *dumb* deregulation: “We need to get rid of bad regulation

³ Credit Squeeze at 41-42.

that stifles competition and inhibits innovation, but we need to improve regulation where it can make markets work better and avoid crises.”⁴ The importance of crafting *reasonable* regulations that do not hobble the innovativeness and dynamism of U.S. financial markets is a consistent theme of Credit Squeeze, and Litan, Baily and Elmendorf take pains to defend their regulatory proposals against the criticisms that they evidently anticipate on this score. Given the questionable social value of some recent financial engineering, the authors are perhaps *overly* concerned about the dangers of stifling financial innovation by over-regulation.

Short-Term Policies to Resolve the Credit Squeeze

The second section of Credit Squeeze, and the shortest, reviews the measures that have already been taken to address the financial crisis. The authors generally approve of the policy responses thus far: the fiscal stimulus (“timely, targeted, and temporary”), the Fed’s “aggressive” reductions of the federal funds rate and expansion of discount window lending, and the “rescue” of Bear Stearns. While acknowledging the moral hazard in protecting Bear’s counterparties from losses, they deem it a price worth paying, given the risk that allowing Bear to fail would trigger a run on other investment banks that are similarly dependent on short-term funding. In a fascinating comparison with regulators’ “hands-off” reaction when Drexel Burnham failed in 1990, Litan, Baily and Elmendorf point out the enormous growth between 1990 and today in securities repo credit, both in absolute terms and in comparison with bank deposits. Citing an entry in the *The Wall Street Journal*’s blog of March 17, they claim that when Drexel failed, such credit amounted to \$372 billion, equivalent to 13 percent in federally insured bank deposits, whereas today securities repos amount to \$2.6 trillion, equivalent to 60 percent of total bank deposits.⁵ Because two thirds of repo loans must be rolled each day, the authors conclude that the Fed “understandably feared a ‘run’ on the repo market had it not intervened to provide liquidity to Bear Stearns, much as it fears a run on ‘bank deposits’ in the event of a failure of a large commercial bank.”⁶

⁴ Id.

⁵ Credit Squeeze, 69-70 n. 31.

⁶ Id.

To be sure, Credit Squeeze does not approve of everything that policy makers have done to address the credit crisis, and they offer various recommendations for additional steps to be taken in the near term, some of which are already being pursued. They urge active consideration of contingency plans for Fannie Mae and Freddie Mac but, in disagreement among themselves, do not make a recommendation as to the course that should be followed. Instead, they content themselves with a discussion of the pros and cons of three options: largely retaining the status quo; full privatization; and nationalization. Litan advocates the adoption of a prompt corrective action regime for the GSEs (PCA is a feature of the GSE reform bills passed by both House and Senate).

The authors also support more aggressive measures to address mortgage foreclosures. Among their recommendations are legislation to confirm that mortgage servicers' fiduciary duties are owed to mortgage pool owners as a whole, rather than to any particular tranche of ownership, thereby giving servicers greater latitude to modify the underlying mortgages. They also reluctantly support "limited" bankruptcy reform to allow some "strip-downs" of mortgage debt (recognizing the negative impact that even limited steps in this direction could have on the cost and availability of mortgage credit for low-income families); and expanding eligibility for FHA-guaranteed loans to refinance existing mortgages, as both Senator Chris Dodd and Congressman Barney Frank have proposed.

Long-Term Reforms to Improve the Financial System

It is difficult to do justice in this brief review to the third section of Credit Squeeze, which contains a detailed discussion of the authors' various long-term proposals for reform of the financial system. In their public presentation of their paper on May 16, Litan, Baily and Elmendorf identified three broad themes:

- Financial institutions should be more transparent.
- Financial institutions should be less leveraged and more liquid.
- Financial institutions should be supervised more effectively.

Regarding mortgage origination, they believe that transparency would be advanced by adoption of simpler disclosure and mandatory *pre-mortgage* counseling for subprime borrowers. They strongly endorse adoption of a one-page disclosure form very like the one proposed by

Alex Pollock, an experienced banker and former President of the Federal Home Loan Bank of Chicago who has been a Resident Fellow at the American Enterprise Institute since 2004. The form is accessible on AEI's web site at <http://www.aei.org/scholars/scholarID.88/scholar.asp>.

Some of the suggestions regarding mortgage origination go beyond improving transparency and amount to substantive regulation of the types of mortgages that can be offered. They propose as one option offering a standardized mortgage form from which borrowers could opt-out. They oppose prohibiting all prepayment penalties, but are inclined to support banning yield spread premiums. With some apparent ambivalence, they also endorse a "suitability" requirement for mortgages, but would soften the blow by limiting enforcement authority to regulators or other public agencies. The authors also generally support the Federal Reserve's strengthening of HOEPA and other mortgage protections (not yet finalized in May) and Treasury's proposal to establish a Federal mortgage origination commission to oversee state regulation of mortgage originators. To solve problems with the "originate to distribute" model of mortgage origination, Credit Squeeze suggests consideration of requiring originators to retain some portion of the assets on their own books, as well as improving transparency in the rating process.

Several startling suggestions in the paper relate to addressing what the authors perceive as shortcomings in current bank capital requirements. They reiterate the by-now common criticisms of the Basel II regime's reliance on rating agencies and banks' internal risk models, on the grounds that these have been thoroughly discredited in the run-up to the current crisis. They also criticize Basel II's lack of capital requirements for ostensibly off-balance sheet securitization vehicles, and the failure to address bank liquidity. Litan (but not his co-authors) goes so far as to suggest eliminating the risk categories altogether, in favor of a simple leverage ratio. All agree that bank regulators should pay more attention to rapid asset growth as a harbinger of problems, and recommend that banks be required to issue subordinated debt to enhance market discipline of bank risk-taking. In a portion of the paper that is oddly reminiscent of neocon screeds against multilateralism in U.S. foreign policy, Litan, Baily and Elmendorf

urge U.S. regulators “seek, but not wait for, international cooperation” in making necessary improvements to bank capital regulation.⁷

As to regulatory restructuring for more effective supervision, they are for it. But as Litan said in the public symposium, moving the regulatory boxes around is a long-term project, and “it’s a lot more important what goes inside the boxes than where the boxes are.”

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⁷ Credit Squeeze at 141.