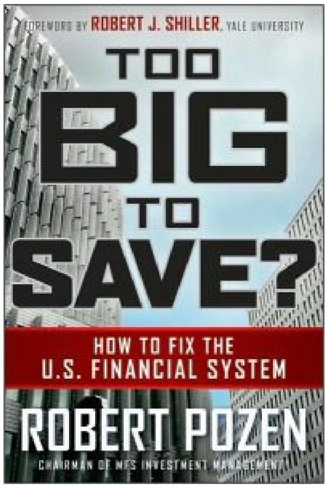


# Book Too Big to Save?

## How to Fix the U.S. Financial System

Robert Pozen
Wiley, 2009
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## Recommendation

Stable, sustainable economic growth requires new approaches to financial regulation. In this insightful book, Robert Pozen explains how speculative securities underwriting, easy mortgage financing and poor regulation led to the worst U.S. recession since the 1930s, as well as a worldwide financial crisis. An industry leader in investment management, Pozen proposes regulatory reforms to make the financial system less vulnerable to similar problems in the future. Readers may disagree with some of Pozen's recommendations, and as the U.S. government adjusts its regulation of financial institutions, some of his proposals may become moot. However, his accessible, informed text also offers a remarkably clear account of how the recession unfolded in the United States. That's more than enough reason for *BooksInShort* to recommend this intelligent book to anyone interested in global financial fragility and how to fix it.

## Take-Aways

- In late 2007, mortgage-backed securities sank in value as foreclosures increased and home prices fell, tipping the U.S. economy into recession.
- This set the stage for a global financial panic in late 2008, in part because issuers in the U.S. sold subprime mortgage-backed securities to investors worldwide.
- To improve credit availability, policy makers must revive loan securitization.
- If lenders had to retain fractional ownership of each mortgage they sell, loan quality would improve.
- Government bailouts should go only to large banks that could fail and cause others to fail.
- The Federal Deposit Insurance Corporation should cut its 100% guarantee of bank debt to 90%.
- Requiring "mega banks" to hold more capital would insulate the financial system from further shocks.
- Mega banks need involved "super directors" with expertise in finance.
- Global financial crises put the U.S. at greater risk than any other country.
- Countercyclical government policies reduce economic volatility.

## Summary

### The Subprime Roots of the Recession

Mortgage foreclosures led the United States into a deep recession in late 2007, primarily due to risky lending and lax regulation. This set the stage for a global financial panic in late 2008. The financial crisis began to take shape as home loans to subprime borrowers and the sale of securities backed by such loans multiplied while housing prices soared. Then mortgage foreclosures surged, housing prices slumped, consumer spending slowed, recession emerged and economic growth stopped. How did this happen?

> "It is simply untrue that the failure of any large financial institution would wreak havoc upon the entire financial system."

The Federal Reserve contributed to unsustainable growth in housing by keeping interest rates too low for too long. The Fed kept short-term rates low from 2002 until 2006, well after the housing boom had begun. These low rates encouraged excessive mortgage financing and refinancing. Many mortgage lenders provided subprime loans with low initial monthly payments and set adjustable interest rates linked to yields on short-term U.S. Treasury securities.

> "The critical link between the crash in U.S. housing prices and the global financial crisis lies in the process of mortgage securitization."

For lenders, finding underwriting money was relatively easy. They raised cash for subprime mortgage lending by selling their loans instead of keeping them, so their revenue came mostly from fee income. With these transactions, lenders also transferred the risk of their subprime loans to investors in the secondary market for mortgage debts. The biggest secondary-market mortgage buyers are government-sponsored enterprises meant to expand home ownership: the Federal National Mortgage Association (FNMA, or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC, or Freddie Mac). They own or guarantee about half of outstanding U.S. mortgage loans and issue interest-bearing, mortgage-backed securities (MBS). As "buyers of last resort," they became the leading subprime mortgage buyers from 2002 to 2006, "taking on $5 trillion in debt supported by little capital."

> "The volume of lending in the United States is driven mainly by the loan securitization process, which is used extensively by nonbank lenders as well as banks."

Wall Street also emerged as a primary source of funds for subprime mortgage lenders. In 2002, major investment banks, including Goldman Sachs, J.P. Morgan and Morgan Stanley, began competing with Fannie Mae and Freddie Mac for the MBS business. They were so successful at buying mortgages and reselling them as interest-bearing securities that Fannie and Freddie lost market share. Nonagency issuance accounted for 32% of the outstanding MBS in 2006, up from 15% in 2002. Wall Street made mortgage securities and related derivatives its primary source of profit, selling them to domestic clients and foreign banks, businesses and government agencies.

> "Bank sponsors put together pools of mortgages in special purpose entities, which then issued several tranches of mortgage-backed securities with different interest rates for different risk levels."

But by the end of 2008, an increase in mortgage defaults and foreclosures flattened the market for nonagency mortgage-backed securities. Lenders had made many loans with no intention of holding them, so the quality of mortgage loan underwriting had deteriorated. These institutions commonly approved mortgage loans without verifying the borrowers' incomes or credit histories. Subprime loans also can include additional risky features, such as all-interest payment options, which can cause negative amortization, that is, increases in unpaid principal.

## The Financial Panic of 2008

Doubt about mortgage-backed securities' value contributed to fear about the liquidity of major financial institutions in 2008, one of the most volatile years in U.S. economic history. Early that year, MBS losses at investment bank Bear Stearns led to federal intervention. In March, the government arranged for competitor J.P. Morgan to buy control of Bear Stearns for a nominal price.

> "Investors in turn often bought a kind of protection called credit default swaps (CDS) from highly rated insurance companies as well other financial institutions."

Later in 2008, similar problems at other financial institutions required additional intervention, but the regulatory response varied. In the first week of September, the U.S. government addressed deepening losses at Fannie Mae and Freddie Mac by putting both into conservatorship and recapitalizing them. About a week later, the government let Lehman Brothers, an investment banking giant, file for bankruptcy. By month's end, two other major investment banking firms, Goldman Sachs and Morgan Stanley, won government approval to convert to bank holding companies for regulatory purposes. This status gave them more financial flexibility but also put them under tighter regulatory control. By year's end, the financial institutions carrying the biggest risks on subprime mortgage loans had either failed or undergone major restructuring.

> "The United States needs major reforms to restore the loan securitization process on a permanent basis."

As MBS losses transformed Wall Street, overnight lending among banks in the U.S. and around the world quickly collapsed. So did sales of commercial paper – the short-term interest-bearing notes that large public companies issue routinely. Big banks and businesses suddenly lacked credit if they held mortgage-backed securities or offered them as collateral, or if they were at risk of losing money due to the Lehman bankruptcy. Financial panic spread. The absence of overnight lending among major U.S. banks posed a serious threat to daily payment processing, stoking fears that conducting normal business transactions would become more difficult.

> "Without substantial reductions in mortgage principal...there is a high likelihood that homeowners with shaky finances will default again on their modified mortgages."

The U.S. government came to the rescue. In October 2008, Congress passed and President George W. Bush signed historic legislation allocating $700 billion to recapitalize banks to reduce the risk that mortgage losses would erase their equity capital. As a result, the government became a minority equity investor in several large banks. The overall bailout effort included extraordinary assistance from the Federal Deposit Insurance Corporation (FDIC) and the Fed. The FDIC expanded its maximum insurance coverage per depositor from $100,000 to $250,000 to give depositors of large sums more incentive to keep their money in FDIC-insured banks. The agency also guaranteed 100% repayment of most debt issued by eligible banks and their parent firms until mid-2012. By April 2009, the FDIC had guaranteed more than $300 billion in bank debt.

> "Given the decline in investor discipline and market competition, the monitoring of financial institutions has been left mainly to federal regulators."

The Federal Reserve also did a great deal to ease the late 2008 financial panic and stabilize credit. It lent to commercial and investment banks, accepting illiquid securities as collateral. It also lent to private investors who were willing to buy doubtful assets from troubled banks and bought commercial paper directly from industrial firms. In the process, the Fed vastly enlarged its balance sheet. As of March 2009, it was exposed to potential bailout losses totaling $7.3 trillion.

## Assessing the Bank Bailout

The bank bailout that began in 2008 was flawed. The government put too much capital into too many banks, some of which already had enough. Many of the institutions it helped are community banks with minimal impact on the national economy. Government-funded bailouts should go only to large banks whose demise could sink many other large banks. In addition, the U.S. Department of Justice should reject proposed mergers of large banks if the failure of the combined entities would destabilize the financial system.

> "The adverse repercussions of Lehman's failure resulted primarily from the implicit expectations created by the federal bailout of all bond holders in Bear Stearns in 2008."

The Treasury Department used much of the bailout money to buy minority ownership stakes in banks. Avoiding majority ownership may minimize the public's perception that the government nationalized certain banks. However, majority ownership of a bailed-out bank would be a better approach because although the government would potentially have a lot to lose, it would also have a lot to gain. Minority ownership exposes taxpayers to severe losses if the bailout fails and brings them only limited gains if it succeeds.

> "A freestanding investment bank is more likely to fail than a universal bank combining traditional banking functions with securities activities."

The FDIC has been overly generous to banks. Instead of guaranteeing 100% of the debt that eligible banks issue, the FDIC should guarantee 90%. Guaranteeing 100% creates "moral hazard" in that it kills potential investors' incentives to apply due diligence and to work to assure a bank's creditworthiness before they invest in its bonds. By guaranteeing 90%, the FDIC, in effect, would get outside help from bond investors who would participate in determining a bank's financial health and detecting risky practices. The FDIC also should reduce the present maximum amount of insured deposits from $250,000 to the previous ceiling of $100,000. The jump to $250,000 already is set to expire in 2013. The main purpose of FDIC coverage is to insure small depositors who are unable to determine how safe a bank is. The $250,000 limit increases the cost of bank failures but doesn't add any extra protection for small depositors with account balances of several thousand dollars or less.

## Financial Accounting Issues

"In truth, there is no perfect accounting system for financial institutions," but even so, problems with accounting made only fairly minor contributions to the conditions that created the 2008 fiscal crisis. For instance, banks commonly report the historical costs of their assets, instead of the fair market value. Some banks may use this method of accounting to overstate their true worth, particularly if their assets' value has declined. However, requiring banks to estimate the fair market value of every asset at the end of each quarter – a practice called mark-to-market accounting – is bad for the economy. This tactic is procyclical: It tends to extend economic upturns and downturns. With mark-to-market accounting, bank estimates of asset values would increase and decrease alongside economic activity. With historical cost accounting, asset values are fixed, regardless of the economy's flux.

> "The Treasury should not recapitalize all mega banks in a pre-emptive move to prevent deterioration in the financial sector."

Changing the standards for off-balance-sheet accounting could be counterproductive. During the housing boom, banks commonly ran mortgage-backed security ventures through so-called special purpose entities (SPEs) with separate balance sheets. This boosted the banks' financial leverage. Because these "shell companies" were "accounting orphans," banks could avoid regulations that required them to set aside capital to cover their investments' risks. By 2007, though, increasing foreclosures raised doubts about the true financial condition of SPEs and their bank sponsors. As of November 2007, major banks reversed their policies and began including their SPEs' assets and liabilities on their balance sheets.

> "The Justice Department should reject any merger or acquisition of a financial institution if the resulting institution is likely to pose a serious risk to the financial system or is likely to be subsequently considered too big to fail."

Though vulnerable to misuse, separate accounting for SPEs can serve a useful purpose by making these enterprises easier to understand. Still, the regulations need changing. The U.S. should make banks disclose all SPE obligations in detail. The Securities and Exchange Commission (SEC) should require SPEs to offer increased disclosure when they publicly sell securities.

## Fixing the Financial System

To improve credit market conditions, the U.S. must revive loan securitization. Loan-backed, interest-bearing security issues have been extremely limited since 2008, resulting in reduced funding for mortgage loans – and for car loans and student loans. Slumping loan securitization has constrained credit availability. Investors' lack of confidence in mortgage-backed securities is one reason for the slump. The U.S. government should help rebuild trust by requiring lenders to retain fractional ownership of each mortgage they sell. That would give them adequate incentive to underwrite the risks properly. Banks can manipulate mortgage securitization, but it provides important benefits, such as "diversification." The assets underlying many mortgage-backed securities are loans on properties in various places. A California mortgage lender, for example, could diversify its credit risk by buying securities backed by mortgages from other states.

> "The recycling of global capital makes the world more vulnerable to financial crises."

The government also should set dynamic capital requirements for all banks. Minimum ratios of capital to assets should vary with changes in economic activity. Under this countercyclical approach, regulators would require banks to meet higher capital ratios during economic expansions and lower capital ratios during recessions. Setting tougher capital requirements for the largest banks would make the financial system more stable. Top-tier banks should set aside proportionately more capital to absorb possible loan losses than smaller banks. These "mega banks" need highly qualified directors with expertise and experience in sophisticated financial management. Many banks have flopped because they packed their boards with independent but inept directors. Each mega bank also needs financially skilled "super directors" who will spend several days each month attending to board duties.

The stakes are enormous. The U.S. and other industrialized countries must prevent large bank failures – or, at least, minimize their impact. The countries with the most sophisticated financial sectors face the biggest problems in a global financial storm like the 2008 crisis – and no country is more vulnerable to such crises than the United States.

## About the Author

**Robert Pozen** is chairman of MFS Investment Management. He is a senior lecturer at the Harvard Business School. Pozen chaired a committee on financial reporting improvements that advised the Securities and Exchange Commission in 2007 and 2008.