The Way Forward: Incentives, Not Regulations

William Poole

Most of the world today is concentrating not on the way forward after the crisis, but the way out of the crisis. This concentration brings the very real danger that steps taken now will cause problems later. The most obvious danger, perhaps, is that enormous government spending, here and abroad, will increase outstanding debt to a degree that will increase temptation to attempt to finance government budget deficits through inflation. Moral hazard is the less obvious, but perhaps more serious, problem we will face.

Before I dig into this subject further, I want to make clear that my perspective on the source of the financial crisis is that the crisis was fundamentally caused by mistakes in the private sector—mistakes in private financial firms—and not by mistakes of the federal government. I know that is not a view, as we have heard, that is necessarily universally shared. I'll proceed by first outlining the case for that view. Then, I'll discuss the role of the federal and state governments in creating the crisis, a secondary role as I have already argued. And finally, based on my analysis of the source of the crisis, I will discuss steps that would help create a more stable financial environment in the future.

Mistakes by the Private Sector

Many firms—commercial banks, investment banks, hedge funds, and others—became enamored of subprime mortgage products because of the expectation of a high return in what was otherwise a

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low-return world. These investors were sloppy in their credit analysis. Although it is true that residential real estate prices had not declined on a national average basis since the Great Depression, particular regions of the United States had experienced declines. Moreover, particularly after the collapse of the tech bubble in the early part of this decade investors should have considered the possibility of falling house prices. The rating agencies especially were responsible for poor credit analysis. The issue, incidentally, is not whether a forecast of declining house prices was appropriate, but whether there was a risk of declining house prices. Surely, no knowledgeable analyst would ever say that there was no risk of decline in an asset price.

Beyond weak credit analysis, many managers exposed their portfolios to extreme asset/liability duration mismatch. Mortgages are inherently long-term assets. Portfolio managers should not have financed them with short-term liabilities, such as commercial paper. And to compound the mistake, portfolios were highly leveraged. Capital ratios of 3–5 percent were not uncommon. AIG would have failed in mid September, were it not for the Federal Reserve bailout. The problem there was that AIG sold credit default swaps without maintaining an adequate reserve against possible losses.

The federal government did encourage the subprime mortgage market in a general way, but did not put its stamp of approval on any particular subprime products, or push any commercial or investment bank to buy subprime mortgages. An asterisk to this statement is that the Community Reinvestment Act did encourage, and even require, commercial banks to invest in lower-quality assets, but not in any particular direction. Even there, commercial banks went far beyond any reasonable interpretation of the CRA, and investment banks are not subject to the CRA. Thus, the federal government, while not without blame, was not the main reason for the crisis. The CRA has been law, after all, since the late 1970s, and there was no recent discontinuity in the interpretation or administration of the law that could explain banks' accumulation of subprime mortgage assets.

In sum, I hold the market responsible for the financial crisis. The AIG situation and the poorly constructed mortgage portfolios were the responsibility of the private firms. The basic regulatory framework and tax law governing financial firms has been in force for two decades or more. I regard the repeal of Glass-Steagall and the end of restrictions on bank branching across state lines as not being especially important for present purposes. Neither of these changes affected investment banks and rating agencies except insofar as freer markets created a more competitive environment. In any event, pro-market economists cannot blame reduced regulation for the crisis.

My criticism of private financial firms is widely shared by those who want more government regulation. I believe that free-market advocates who do not want more regulation, and I certainly count myself in this group, need to accept the fact that the market screwed up. The solution is not more regulation, but a change in government policy to improve the incentive structure firms face, so that they will pursue financial strategies that reduce the risk of systemic financial failure.

Government Mistakes

Government mistakes certainly did play a role. Federal government sponsorship of Fannie Mae and Freddie Mac contributed to the failure of those two very large firms. Both operated with too little capital because of the implied guarantee of federal backing, which has now become an explicit guarantee. The federal government pushed both firms to accumulate subprime mortgages in pursuit of its affordable housing goals. But the role of these two firms in the crisis turned out to be rather minor. Events surrounding their being taken into conservatorship in early September 2008 created relatively small problems in the financial markets. Bailing out Fannie and Freddie will be expensive to taxpayers, and we face the unfortunate prospect of almost complete federalization of the residential mortgage market.

Some emphasize that federal and state governments failed to adequately regulate state chartered mortgage companies that originated most of the subprime mortgages. My view is that the subprime mortgage was a useful innovation. The problem was that investment banks and investors simply took the innovation much too far. The massive increase in subprime mortgages helped to bid up house prices, and probably reflected the deterioration over time in credit standards.

Improving Financial Stability

Now, whatever the cause of the crisis, we need to improve financial stability. Very high leverage has been the biggest single contributor to the crisis. It is interesting to compare the effects of the dot-com bust and the house price bust. After the stock market peak in 2000, the NASDAQ average declined by about 75 percent without creating a financial crisis. Conversely, just the beginning of the house price decline led rather quickly to financial crisis. The difference was leverage. Much subprime mortgage paper was held in highly leveraged portfolios, whereas the dot-com equities were held mostly in unleveraged accounts.

It would be simple, conceptually at least, to reduce the incentive for leverage by changing the tax law. The deductibility of interest in the corporate tax law could be reduced or eliminated over a period of years. At the same time, the statutory corporate tax rate could be lowered from 35 percent to whatever level makes the tax change revenue neutral. Firms now operating with little leverage would receive a tax cut, and those operating with high leverage would experience a tax increase. High leverage has proven to be socially costly; a tax penalty for leverage is appropriate. This simple change in the U.S. corporate tax law is market friendly. It would not impose new regulatory burdens.

A condition contributing to the financial crisis was the organization of credit default swaps market. The market is entirely over-the-counter with each swap negotiated separately between the counterparties. The AIG experience shows that the market did not adequately enforce the maintenance of collateral or reserves against the swap positions. If the credit default swaps market were organized through an exchange, the exchange would be the counterparty and would enforce margin collateral. The exchange would sell out swap positions before they became deeply under water.

From what I understand, introducing an exchange for trading credit default swaps has been discussed for several years, but resisted by investment banks and others that found over-the-counter swaps a rich source of fees. An organized exchange would provide more pricing transparency, and strict adherence to margins would be a source of stability. The reform would be market friendly. There would be no need to ban over-the-counter swaps but, presumably, the advantage of exchange-traded swaps would move much of the market to that location, as has happened with many other derivatives markets.

It appears that the federal government will operate Fannie Mae and Freddie Mac for the indefinite future. These companies have a financing advantage over private companies—private competitors—because of their access to funds at interest rates close to those paid by the U.S. Treasury. Parenthetically, I assume that the currently elevated spreads on agency obligations will disappear over time. Fannie and Freddie have increased their market share over the past 20 years and this trend is likely to continue, until the entire mortgage market is effectively federalized. Fannie and Freddie rules on what mortgages can be securitized will control the structure of mortgages. These rules will tend to stifle innovation, and prevent emergence of strong private competitors. The only way around this prospect is to phase out Fannie and Freddie over time. I see absolutely no reason for federalization of the mortgage market, but that unfortunately seems to be the prospect.

The Danger of Excessive Regulation

Many observers want more regulation to ensure financial crises cannot recur. As I read the plea for more regulation, I see no specifics for what regulations would accomplish that task. I fear that Congress will pass sweeping new regulatory authority with financial stability objectives—that is, fancy preambles in the legislation—but no clear idea how to accomplish the objective. Regulatory agencies will be directed to solve the problem. Regulatory agencies will probably try to ban certain financial instruments thought to be dangerous. Payday loans might be an example. An attempt to ban such loans will simply drive the market underground. An attempt to ban certain sorts of mortgages could lead to the same result. Or, if effective, such bans will stifle innovation. The subprime mortgage was a useful innovation introduced by largely unregulated mortgage companies, and not by the federally regulated depository institutions. If such innovations are made impossible, subprime borrowers will not have future access to credit, except through costly federally subsidized programs.

Those who want more regulation should keep two facts in mind. First, regulation will inevitably be bent to serve political purposes. Of course, that is exactly what some pro-regulation observers want. Before the financial crisis, many members of Congress cheered subprime mortgages because they served affordable housing goals. Second, the financial economy is inherently very competitive. With access by Internet, for example, many financial firms could relocate abroad, thus escaping federal jurisdiction.

Moral Hazard

Actions this year are creating moral hazard to an unprecedented degree, and unwinding the situation will be costly. We are clearly seeing the effects already. Lehman, I believe, delayed raising capital expecting it would receive the same sort of treatment that Bear Stearns did. Lehman was instead permitted to fail. Investment banks have become bank holding companies, so that they would qualify for Federal Reserve resources. There are reports that GMAC and insurance companies are trying to convert to bank charters, in one way or another, to become eligible for Fed support and for the Treasury capital infusion program for banks. Auto companies are asking for access to the $700 billion TARP fund. The Federal Reserve and the federal government need to move quickly to limit which firms have access to government resources. The Federal Reserve should put a moratorium on all conversions of corporate charters to commercial bank charters.

Congress should refuse to bail out any more firms—weak firms should be required to seek protection under the bankruptcy law. The clear fact is that the greater number of firms bailed out in coming quarters, the greater will be the number of applicants for bailouts. I see no way to decide which firms are deserving of a bailout, and which are not. Members of Congress should understand that for every firm bailed out, there will be many others seeking funds. Most of these firms will necessarily be disappointed. The same will be true for individuals seeking mortgage relief through government programs.

The issue is not just disappointment, of course, but that firms and households hoping for bailouts will fail to take appropriate action to adjust to changed economic circumstances. Mistakes will be larger, and adjustment delayed when bailouts are expected but denied.

Tax Reform and Monetary Policy

The only way to avoid a moral hazard mess—a mess that, in time, is going to rival this current financial mess—is for Congress to provide generalized assistance through the tax law, and then walk away from all of the specific bailout requests. A cut in the corporate tax rate, with generous carry-forward and carry-back provisions, will assist firms that have a chance of survival. Others should reorganize themselves through bankruptcy.

The most desirable fiscal policy steps will be those consistent with the long-run needs of the economy. Revisions in the corporate tax law to encourage business fixed investment should be at the top of the list. Capital outlays should be expensed for tax purposes, rather than depreciated over time. Short of that, investment tax credits and accelerated depreciation would be appropriate. Stimulating investment, after all, was a key objective of the Kennedy administration when it came to power in 1961. The same approach is needed today. The economy needs more investment and less consumption over the long run. Any stimulus bill should be consistent with that objective.

I support current Federal Reserve monetary policy, at least if I think I know what the Federal Reserve is doing. It is important that the economy not be permitted to enter a downward spiral leading to deep recession and ongoing deflation. As the situation stabilizes, however, the Fed will have to pull back the bank reserves it is now creating. Otherwise, the result will be an eventual increase in inflation that will create major new problems.

Conclusion

The way forward is to enact tax law changes that will improve the long-run stability of the economy by reducing the incentive for leverage, and by encouraging a substitution of business investment for consumption. And on the monetary policy front, the Fed must be prepared to reduce policy accommodation as the recovery takes hold.