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Dangerous Dithering: Congressional Inaction Plants the Seeds of Crisis

By Peter J. Wallison

"Neither man nor his property is safe while the legislature sits," goes an old maxim. Although there is much bitter experience embedded in this idea, it is also true that the failure of our own national legislature to take necessary action can be equally calamitous. For several years, important groups have warned that the United States is losing its preeminence in the world's financial markets because of excessive regulation and litigation risk. One of these studies was cosponsored by a key member of the Senate, Charles Schumer (D-N.Y.). Yet no action has been taken—not even a hearing—on Capitol Hill. For more than a year, legislation adopted by the House of Representatives to reform and improve the regulation of Fannie Mae and Freddie Mac has languished in the Senate Banking Committee. Now that the financial markets are in turmoil and the subprime meltdown is causing serious losses for the two government-sponsored enterprises (GSEs), it is becoming clear that continued failure to act could turn a mortgage market problem into a disaster for taxpayers. Yet the Senate Banking Committee is still unable to pass—or even take up—a perfectly adequate House bill. It is no wonder that public approval of Congress has fallen so low and that the presidential candidates of both parties are campaigning to bring change to Washington.

It is a cliché that Congress acts only in a crisis, but few observers revisit crisis legislation to discover whether Congress could have prevented the turmoil and losses suffered in the crisis and crafted better legislation by acting when problems were known and manageable. There are two current and glaring examples of this dangerous dithering: the gradual loss of financial business to foreign markets and the failure to adopt legislation that would subject Fannie Mae and Freddie Mac to adequate regulation. Congress has been warned about both situations, yet neither issue has received the attention or the action it deserves. The outcome may well be that future crises will result in ill-advised and hasty legislation.

The Decline of U.S. Financial Market Preeminence

The loss of financial activity to markets abroad has been documented again and again since it first became an issue in the summer of 2006. Four reports by respected groups—the U.S. Chamber of Commerce,[1] the Financial Services Roundtable,[2] the Committee on Capital Markets Regulation,[3] and Senator Schumer and New York City mayor Michael Bloomberg[4]—have all noted the gradual withdrawal of financial transactions from U.S. public securities markets and laid the cause at the door of excessive regulation and the high litigation risk associated with private class actions. The current turmoil in the financial markets has little to do with this issue. All these studies point to excessive regulation of securities *issuers*—not broker-dealers like Bear Stearns—or subjection of these issuers to substantial litigation risk with little public benefit. Indeed, the inevitable loss of confidence in U.S. financial markets as a result of the Bear Stearns collapse will only exacerbate the adverse trends that these reports highlight. If greater regulation of the securities business does, in fact, result from the Bear Stearns case, it will only increase the costs and reduce the innovativeness of U.S. broker-dealers,

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creating further obstacles to a U.S. recovery of its former position.

The most up-to-date information about the current trend away from the United States comes from the report of the Committee on Capital Markets Regulation, a group of academics and market experts assembled by Hal Scott of Harvard Law School. The December 2007 report, focusing on the public securities markets, shows that the trend away from the United States is growing more pronounced. One of the most stunning statistics in the report is the proportion of all initial public offerings by U.S. companies occurring overseas (primarily in London). The number was negligible before 2005 and a little over 1 percent in 2006. According to the new report, it is slightly over 4 percent. The fact that U.S. companies would feel it necessary to offer their shares to the public for the first time in a foreign market speaks volumes about conditions in the United States today. Other data in the committee's report are equally worrisome: The U.S. share of global market capitalization, which had been an average of 43.6 percent between 1990 and 2005, was 37.9 percent in 2006 and 35.2 percent in 2007; equity raised by foreign issuers in the U.S. private markets, which averaged 6.8 percent of the equity raised in the U.S. public markets for the years 2000– 2005, was at 31.2 percent in 2006; and 12.4 percent of foreign companies delisted from U.S. markets in 2007, compared to an average of 5.2 percent between 1997 and 2005.[5]

The Securities and Exchange Commission (SEC) has not been picking up the slack associated with congressional inaction on issues of importance to the public securities markets. A recent article points to long delays that brokers encounter in getting SEC guidance on the three-year-old electronic trading rule known as Regulation NMS,[6] which has made the public trading of securities in the United States needlessly more expensive. Ten Nasdaq applications filed with the SEC over a year ago have yet to be acted upon. While the SEC made a sound decision in support of a globalized securities market by proposing to allow foreign companies to use International Financial Reporting Standards when offering their shares or reporting to their shareholders in the United States, the agency has not weighed in with Congress to point out the more important costs that are driving both foreign and U.S. companies away. It is becoming apparent that the efforts of the New York Stock Exchange and Nasdaq to acquire foreign exchanges are based at least in part on a recognition that exchange-based securities trading outside the United States is where future growth will be.

The lack of congressional action is particularly odd because Senator Schumer, one of the sponsors of the Bloomberg-Schumer report, is also one of the most powerful members of the Senate. He is a member of the Senate Banking Committee, which has jurisdiction over the securities markets, and, as a key member of the Democratic majority on the committee, he could have induced some action on the findings in the report if he were truly interested. Among the most trenchant points of his report are these:

- "The legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation. While nobody should attempt to discourage suits with merit, the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business—and driven away potential investors."[7]

- "Empirical evidence certainly suggests that litigation has become an important issue: 2005 set a new high for the number of securities class-action settlements in the U.S., and for the overall value of these settlements. Of course, many of these cases addressed the legitimate claims of investors and consumers in situations of notable corporate wrongdoing. However, in aggregate, some of the unique characteristics of the U.S. legal environment are driving growing international concerns about participating in U.S. financial markets—concerns heightened by recent cases of perceived extraterritorial application of U.S. law."[8]

- "The SEC should make use of its broad rulemaking and exemptive powers to deter the most problematic securities-related suits. For example, the SEC could invoke Section 36 of the Securities Exchange Act of 1934, which effectively allows it to exempt companies from certain onerous regulations where it deems such exemptions to be in the public interest."[9]

- "Legislative reform is also needed to address the long-term, structural problems that underpin the trend toward increasing litigation in the securities industry. Congress should thus consider legislative means of addressing concerns around the quantity and unpredictability of litigation relative to other countries."[10]

- "Lately . . . the regulatory environment that has served the United States so well in the past has

begun to work against itself. The increasing pace of innovation and new product development in financial services has meant that responsiveness and flexibility have become ever-more important features of regulation. Yet against this need for speed comes regulators' obligation to protect investors and customers, which has hampered efforts to respond quickly to the ever-changing needs of business and the rapidly evolving nature of risk in the markets. While the United States has struggled to balance rapid innovation with consumer and investor protection, other financial markets—most notably London—have grown faster and been nimble enough to adapt their own regulatory regimes to be responsive to businesses, while still safeguarding customers and investors."[11]

- "Not surprisingly, the vast majority of interviewees and survey respondents strongly believe that the pendulum of regulation in the United States has swung too far in recent years. An increasingly heavy regulatory burden and a complex, cumbersome regulatory structure with overlaps at the state and national levels is causing an increasing number of businesses to conduct more and more transactions outside the country. For many executives, London has a better regulatory model: it is easier to conduct business there, there is a more open dialogue with practitioners, and the market benefits from high-level, principles-based standards set by a single regulator for all financial markets."[12]

I quote the Bloomberg-Schumer report so extensively because it contains some of the most forceful and persuasive statements about the twin threats of costly regulation and severe litigation risk as factors in the growing trend away from U.S. capital markets, with particular effect on New York. Regrettably, the lack of action on the report in the Senate suggests that Senator Schumer is not truly serious about the issue but merely wanted to associate himself with it without actually having to do anything. The fact that he heads the Senate Democratic Campaign Committee, which collects substantial contributions from the trial lawyers who would be hurt by any curb on private securities class actions, may account for this lack of follow-up. But more than anything else, his failure to pursue an issue so important to his own state and city is emblematic of a Congress that is more interested in identifying issues and expressing concern about them than disappointing various interest groups by doing the difficult work of solving the problems.

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Fortunately, the migration of financial activity from the United States has not yet become a crisis. That may lie in the future, when the impact on the U.S. economy and particularly New York becomes clearer. But the situation in the mortgage markets has already prompted serious concern about the financial condition of Fannie Mae and Freddie Mac—concern that may provoke a crisis if conditions in the housing market continue to decline. The inaction of the Senate Banking Committee will then look like a serious blunder indeed.

Regulation of Fannie Mae and Freddie Mac

Legislation to reform and improve the regulation of Fannie Mae and Freddie Mac has been languishing in the Senate Banking Committee for almost a year. The House bill, HR 1427, a commendable effort to create an effective regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, was passed on May 22, 2007. Although adopted by a Democratic House, it was apparently unacceptable to the Democratic majority on the Senate Banking Committee. With the mortgage markets in turmoil and Fannie and Freddie under significant financial pressure, the delay in acting on a new regulatory structure for them leaves the country without any effective response in the event that they suffer further deterioration in their financial outlooks.

This poses a stark choice between the interests of the taxpayers and the interests of the managements and shareholders of these two GSEs. By early March, the spread between GSE and Treasury debt was over two hundred basis points, an unprecedented number and a statement by investors that they no longer had complete confidence in

either the financial condition of the GSEs or the willingness of the government to bail them out in the event that their losses in the current mortgage and housing meltdown continue to mount. Data in the recent financial reports of both GSEs provide plenty of cause for worry. Fannie Mae, for example, reported that it held in its portfolio $74 billion in subprime and Alt-A mortgage debt but that it had only about $45 billion in capital. A recent article in *Barron's* questioned the limited size of the write-down on Fannie's subprime and Alt-A portfolio, the real value of some of its assets (such as $13 billion in deferred tax losses), and whether it has properly assessed the size of its liabilities.[13] Clearly, if conditions in the housing and mortgage market deteriorate further, more losses will build up within the two companies. Together, they raised about $13 billion in new capital with preferred stock offerings during the last quarter of 2007, but about half of that new capital had already been eaten through by losses during that quarter.

The possibility that Fannie and Freddie may reach insolvency is no longer dismissed by financial analysts, as the *Barron's* article demonstrates. If it occurs, it would be a calamity for the housing market and the economy generally—a true systemic event. It is not, after all, the health of the two GSEs alone that is at stake. Thousands of financial institutions hold GSE debt—in amounts that exceed their capital, in many cases—and a requirement to write down the value of this debt would weaken the financial system as a whole and surely worsen the economic outlook. What would Congress do in such a dire situation? The initial reaction would probably be a move to declare that their debt, including their mortgage-backed securities (MBS), will be considered full faith and credit obligations of the United States. In March, rumors swept through the markets that such a step was in the offing, and both the White House and Treasury issued strong denials. Indeed, such a step could have momentous consequences. Between them, the GSEs have over $4 trillion in debt (including guarantees of MBS) outstanding. In one stroke, that sum would be added to the outstanding public debt of the United States. Congress would have to think long and hard about doing this, since its impact on the dollar and the credit position of this country could be devastating, and taxpayers would be outraged by this new burden. In addition, such a step would be a huge gift to the shareholders and managements of the GSEs, both of whom would get a new lease on life and an opportunity, like the savings and loans in the 1980s, to play with taxpayer funds to try to recover their profitability. Yet any congressional hesitation on such a momentous decision would compound the problem, with financial intermediaries throughout the United States and the world facing serious declines in their capital positions.

The receiver would have the power to continue the business of the GSEs indefinitely, so the mortgage markets should not be seriously disrupted by their insolvency, and it would even be possible to recreate them as GSEs after their financial stability has been restored—should Congress choose to adopt such an ill-advised policy.

What is the alternative? At the moment, there is none. The GSEs are not covered by bankruptcy or other laws that come into effect when they cannot meet their obligations.[14] Their regulator, the Office of Federal Housing Enterprise Oversight, has authority to take them over as a conservator but nothing more. In most circumstances, a conservator only has the power to continue the business of a company and conserve as much of its assets as possible. A conservator has no authority to wind down a company in an orderly way and pay off its creditors in accordance with their priorities.

This is where the interests of taxpayers and the shareholders of Fannie and Freddie come into conflict. If there is in fact a serious deterioration in the financial condition of the GSEs—to the point of insolvency—there are only three possible courses of action: nationalization, declaring their debt to be full faith and credit, or an orderly windup under the supervision of a receiver. Nationalization would require major legislation and would probably incite bitter disputes over the value to be paid to the shareholders; it would probably not be feasible in the time available. The consequences of the other two options, however, are very different for the shareholders and the taxpayers.

Declaring the GSEs' debt to be full faith and credit would probably stop a panic, but at great expense to taxpayers. It could probably be done quickly with a joint resolution of Congress. In an instant, their cost of funds would decline more than 200 basis points, and concerns about liquidity would end. Share prices would rise substantially. Thereafter, without any new legislation to control their activities, taxpayers would bear the risks of virtually all the losses, as they did with the collapse of the

savings and loans. But if an orderly windup of the companies were to occur under the control of a receiver, the shareholders would be wiped out and the taxpayers' losses would be substantially reduced.

How would an orderly windup proceed? First, Congress would declare that new *debt* issued by the companies *under the control of the receiver* would be full faith and credit obligations of the United States. This would enable the receiver to borrow all the funds necessary to assure the GSEs' creditors that they would be repaid in full as their obligations were to come due. The amount that this would add to the federal debt would not be substantial, since it would consist only of the difference between the value of the assets on the GSEs' books and the value of their liabilities. A substantial portion of the cash necessary to meet the GSEs' obligations would come from the sale of their assets as they are wound down. The receiver's credible statement that all obligations would be met as they come due—backed by the full faith and credit granted to newly issued obligations of the GSEs under receivership—would restore the market for the GSEs' debt and MBS, and thus the capital positions of the institutions that hold this debt. In this arrangement, the shareholders would be wiped out, but taxpayers and the economy would be protected against substantial losses. The receiver would have the power to continue the business of the GSEs indefinitely, so the mortgage markets should not be seriously disrupted by their insolvency, and it would even be possible to recreate them as GSEs after their financial stability has been restored—should Congress choose to adopt such an ill-advised policy.

Stuck in the Senate

This is the best scenario associated with the possible insolvency of the GSEs, but it cannot be followed under current law because the central role for a receiver has not been authorized by Congress. The necessary language is in the bill now stalled in the Senate Banking Committee.

Given the urgency of the situation, why is the legislation stalled? The only logical explanation is that some senators do not understand either the gravity of the situation or the position of the GSEs as private shareholder-owned companies. A clear example of both is a statement by Senator Schumer in a recent hearing:

> Fannie Mae and Freddie Mac have not lived up to my expectations when it comes to assisting borrowers who have difficulty affording their loans. . . . I expect in return for allowing the enterprises to enter the jumbo market, the companies will also make a commitment to fund additional modification resources to lower income borrowers who are having difficulty affording their payments.[15]

It would be difficult to construct a more concise statement that reflects the utter confusion in Congress about the GSEs. Here we have two companies with very limited capital. They have just raised $13 billion in new equity and lost half of it in the immediately preceding quarter. The last thing they should want to do is take on additional financial risk, yet Senator Schumer is clearly expecting them to do so. Moreover, he does not seem to recognize that if the GSEs were actually to use some of their limited capital to support the purchase of the $729,000 jumbo mortgages to which he refers, there would be even less capital available to support the low-income homeowners he wants to help.

The only way to make any sense of this request is to believe that he thinks of the GSEs as government agencies, able and willing to take unlimited losses in support of a national policy. However, as private shareholder-owned companies, this is impossible—and even dangerous. It is impossible because continuous losses from imprudent investments in jumbo mortgages or other congressionally directed instruments will drive their stock prices down and subject their managements to shareholder litigation, and it is dangerous because—as we saw with the savings and loans—private companies that are backed by the government but have no capital to lose will take extraordinary risks to regain their profitability—a phenomenon called "gambling for resurrection." If Senator Schumer's comment represents the typical U.S. senator's understanding of GSEs, there is little hope that they will pass legislation to authorize the appointment of a receiver in case one or both of the GSEs should reach insolvency. An insolvency would impose such calamitous losses on taxpayers and the U.S. economy that it will do little good afterward to assign blame.

So while the presidential campaign continues, with all candidates vowing to bring change to Washington, the unwillingness or inability of Congress to act on needed legislation—despite a great deal of evidence that action is necessary to avoid crisis conditions—provides powerful examples of why Americans are so disappointed with their elected representatives.

AEI research assistant Karen Dubas worked with Mr. Wallison to produce this Financial Services Outlook.

Notes

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4. Michael R. Bloomberg and Charles E. Schumer, *Sustaining New York's and the US' Global Services Leadership*, January 22, 2007, available at www.schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf (accessed March 5, 2007).

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9. Ibid., 20.

10. Ibid., 21.

11. Ibid., 80.

12. Ibid.

13. Jonathan R. Laing, "The Next Government Bailout?" *Barron's*, March 10, 2008.

14. Richard Scott Carnell, "Handling the Failure of a Government-Sponsored Enterprise" (conference presentation, AEI, Washington, DC, February 3, 2005), available at www.aei.org/event996/.

15. Charles Schumer (statement, "Reforming the Regulation of the Government Sponsored Enterprises" hearing, Senate Committee on Banking, Housing, and Urban Affairs, February 7, 2008).