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## Capital Ideas

By Peter J. Wallison

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### **Lawmakers should turn their attention to persuading banks and other financial intermediaries to raise more capital.**



The key question in the so-called mortgage meltdown is whether shareholders or taxpayers are going to bear the loss. The most serious problem we face is not the fact that some homeowners are unable or unwilling to meet their mortgage obligations—as bad as that is—but the fact that the capital bases of banks and other financial institutions have been substantially weakened by the decline in the value of the mortgages and mortgage derivatives that they hold. As a result of this weakness, banks have been forced to reduce their lending, and the lack of confidence in the stability of these and other financial institutions has caused the credit markets to freeze up. The shortage of credit, in turn, is adding to the risk of recession, or its depth if one is already upon us. Thus, the problems in the mortgage markets are affecting the wider economy as well as the lives of the American people—the vast majority of whom are perfectly willing and able to meet their mortgage obligations.

To address this problem, many people are looking to the government to bail out one or another of the participants in this cycle. Government solutions have two major drawbacks—they prolong the crisis and they require the taxpayers ultimately to bear the losses. Private solutions would work better, but what are they?

To consider this question fully, we should go back to first principles.

Banks and other financial intermediaries are required to have capital. The purpose of capital is to cushion them and keep them solvent in times like these when they are suffering losses. If banks and other intermediaries had sufficient capital, they would still be suffering losses today, but we would not be seeing the financial turmoil and fear that is so apparent now in the markets.

Many of the proposals that are coming forward from Capitol Hill and elsewhere are intended to substitute in some way for adequate capital in the banks and other financial intermediaries. For example, the Dodd-Frank proposal unveiled last week would have the Federal Housing

Administration guarantee newly reformed mortgages for those in default. Under ordinary circumstances, adequately capitalized banks and other lenders would renegotiate and carry these mortgages without a federal guarantee. Proposals to create a new Homeowners Loan Corporation, like the one that bought mortgages during the Depression, would have the same effect. They are all using taxpayer funds or inserting taxpayer risk into private markets in order to ease the strain on lenders.

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What's more, proposals to freeze interest rates or have bankruptcy judges reform mortgages to levels that people can afford are intended to place the burden for the losses on the lenders. They will make the problem worse, and probably skewer the mortgage markets for years to come.

But the fundamental problem is the lack of capital—also called excessive leverage—in the lenders. If they had sufficient capital, they could ride out this crisis by taking the losses that their previous lack of prudence produced. Naturally, the lenders are not eager to increase their capital; it dilutes their existing shareholders and drives down stock prices. But given the potential losses that are building in our frozen credit system, shareholders face a Hobson's choice between dilution and failure.

Not surprisingly, banks and others are up on Capitol Hill pushing bailout plans. But politicians of both parties are unwilling to bail out lenders, and the public seems unwilling to bail out either the lenders or the homeowners who imprudently signed up for mortgages they couldn't afford.

Once again, the public seems to have the right idea. Without a bailout, the best solution is an increase in the capital of financial intermediaries. Many have already sought and received capital injections. More are necessary. Regulators are quietly—perhaps too quietly—encouraging this step.

One way to bring it about is to stop the speculation in Washington about who will be bailed out and under what circumstances. Banks and other financial institutions should face the fact that they are going to have to recapitalize, and get on with it.

In this sense, the Fed's bailout of Bear Stearns can be read two ways—as a signal that bailouts will save everybody's bacon, or as a demonstration that waiting too long for a recapitalization could mean financial disaster. The Bear Stearns case shows just how high the stakes in this bet can be. Financial institutions can hope that they will not have to raise more capital, but that may not be how their creditors see it. As housing prices and mortgage values continue to fall, what appears adequate today may be insufficient tomorrow. The only safe course in this environment is seeking and adding new capital. Shareholders may not be happy with the dilution, but it is very likely that the shareholders of Bear Stearns would now be happy with that trade—if it were still available.

In reality, the prospects for recapitalization do not seem particularly bleak. There are many reasons for investors to want to buy into banks and other financial institutions at the low prices to which markets have driven their shares. For one thing, many observers believe that the valuation of mortgages, and the write-downs in assets that have resulted, have not been realistic. Analysts at Standard and Poor's wrote last week, "When we dissect the percentage of writedowns taken against various types of exposures, the magnitude of some writedowns is greater than any reasonable estimate of ultimate losses."

There have been losses, to be sure, but these observers contend that the extreme write-downs are the result of distressed market values and not a true reflection of the value of these assets.

We don't know whether this is true, but if it is, the potential for profit is substantial.

Most Americans are paying their mortgages and will continue to do so. The final losses arising from the mortgage defaults—which some observers have pegged at as high as a trillion dollars—are probably greatly exaggerated. When markets return to normal, the chances are that these values will be written up and substantial profits will be made. This is the way these “crises” usually play out, and there is a lot of money on the sidelines waiting for the bottom and the profit opportunities this will present.

Indeed, the likelihood that their portfolios will ultimately increase in value is a reason that some companies give for not seeking more capital. Freddie Mac, for example, noted in a recent statement, that “the unrealized losses on the [asset backed securities] portfolio as of December 31, 2007, are principally the result of decreased liquidity and larger risk premiums in the subprime market...we have concluded that the impairment of these securities is temporary.” Maybe, maybe not. The potential profit if this is correct should be attractive to the risk capital waiting on the sidelines. The trouble is, this only works if that capital goes into the companies, not into the secondary market.

So what we have is a standoff. Companies that have been compelled to write down their assets believe that they will eventually recover a good portion of that value, but as housing values continue to fall, they are increasingly risking the loss of all if they find themselves with insufficient capital to stay the course. Our political leaders should busy themselves less with figuring out how to bail out the losers and turn their attention to persuading banks and other financial intermediaries to raise more capital.

*Peter J. Wallison is a senior fellow at the American Enterprise Institute. He was General Counsel of the Treasury in the Reagan administration.*