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## False Notes from the Fed, the Treasury, and the SEC

*In recent weeks, the Federal Reserve, the Treasury, and the Securities and Exchange Commission (SEC) have taken actions that could have profound impact on the nation's financial system. Allan H. Meltzer, the nation's leading historian of the Fed, notes that institution's sorry record as a supervisor and regulator and asks why the Fed should now supervise investment banks. Peter J. Wallison concurs and suggests that this drastic policy change is unnecessary and bad news for taxpayers. He urges Congress to nullify the recent memorandum of understanding between the SEC that gives the Fed this new authority. Wallison, a long-time critic of Fannie Mae and Freddie Mac, and Vincent R. Reinhart, a Fed intimate, believe that policymakers should be rethinking the status of the government-sponsored enterprises and the grave risk they create for taxpayers.*

## Keep the Fed Away from Investment Banks

By Allan H. Meltzer

Only in the weird world of Washington are mistakes rewarded with major new responsibilities. After mismanaging both housing loans and the dot-com mess, the Federal Reserve may now become responsible for supervising investment banks.

The proposal by Treasury secretary Henry Paulson to do so could lead investment banks to accept more risk because they will be able to hide some of their mistakes by borrowing from Federal Reserve banks. This is cause for concern in itself. What is more, most of the proposal is unnecessary.

Since investment banks mark their portfolio to market every night, all Congress has to do to keep them in line is set a minimum capital standard. If an investment bank is unable to borrow enough to balance daily with its capital intact, it should become subject to the same Federal Deposit Insurance Corporation Improvement Act (FDICIA) rules that apply to commercial banks. These require reduction or elimination of dividend payments when capital is impaired, followed by a

temporary takeover by a regulator if capital continues to fall. Management would be replaced and stockholders would bear the losses. This rule goes a long way to discourage excessive risk-taking and moral hazard.

These new rules for investment banks would take effect when markets return to normal. At that time, the Fed should end lending to investment banks altogether and begin to repair the damage to its balance sheet by greatly reducing holdings of long-term loans.

History shows that the Federal Reserve is a poor supervisor and regulator. The Fed's board ignored warnings about the risky housing loans that banks were keeping off their balance sheets. This costly mistake is only the most recent of many supervisory failures.

During the 1960s and 1970s, Fed governors discussed the problems caused by the combination of Regulation Q—which restricted the interest rate that banks and thrifts could pay depositors—

and inflation. To escape the ceiling rates mandated by regulators, businesses moved some of their borrowing abroad, and consumers moved deposits from regulated banks and thrifts to unregulated money-market funds. The Fed watched. Its board discussed the issue many times but always found a reason to delay. As a result, taxpayers later paid \$150 billion to cover the losses, and most of the savings and loan industry disappeared.

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During the 1980s Latin American debt crisis, the Fed worked with the International Monetary Fund to hide losses to banks. This mistaken policy continued until management at Citicorp chose to write off its losses. Other banks followed. Later, the Treasury negotiated a reduction in the debt and an end to the crisis.

Over the years, the Fed has shown reluctance to close failing banks, keeping some open even after all their bank capital was gone. The Federal Deposit Insurance

Corporation paid for the losses. Congress ended this lax supervision by passing the FDICIA in 1991. The law now requires regulators to act before all the capital or equity has been lost.

In its ninety-five-year history, the Fed has never made a clear statement of its policy for dealing with failures. Sometimes it offered assistance to keep the bank or investment bank afloat. Other times it closed the institution. Troubled institutions have no way to know in advance whether they will be saved or strangled. The absence of a clear policy statement increases uncertainty and encourages problem institutions to demand loans and assistance. Large banks ask Congress to pressure the regulators. Taxpayers pay for the mistakes.

So what can taxpayers expect from an increase in the Fed's discretionary authority over investment banks? The likely answer is rescues, delays, and lax supervision—followed by taxpayer-financed bailouts. Throughout its postwar history, the Fed has responded to the interests of large banks and Congress, not the public.

Investment banks do not need the Fed to regulate them. Some clear rules on capitalization would suffice.

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## The Fed and Investment Banks

By Peter J. Wallison

Since the Bear Stearns bailout, most commentators in the United States have assumed that the Federal Reserve's action would eventually result in Fed regulation of investment banks—a superFed, as some have called it. But it was always assumed that this would occur through legislative action, as Congress considered whether to place the resources of the U.S. government behind the investment banking industry, as those resources have been placed behind commercial banks.

On July 7, however, with the support of the Treasury, the Securities and Exchange Commission (SEC) and the Fed signed a memorandum of understanding that, in effect, puts the key elements of a Fed regulatory structure—and implicit Fed backing for the large investment banks—into place. What this amounts to is a straightforward Fed reach for important new regulatory authority, an unprecedented step in which a weak SEC—chastened after the failure of Bear Stearns—has been complicit. It would be perfectly acceptable if the agreement covered only the

emergency period the markets are now experiencing, but it has no time limit.

The agreement is very bad news for U.S. taxpayers. Fed involvement with the regulation of investment banks will introduce moral hazard into the securities business for the first time and pave the way for a vast new U.S. government liability. The agreement between the Fed and the SEC will seriously compromise market discipline, which only exists when creditors and other counterparties believe that they are financially at risk. What now amounts to ongoing supervision of the financial condition of investment banks by the Fed sends an unmistakable signal to the markets that the government believes itself to be at risk. Under these circumstances, investors will be justified in believing that the U.S. government will ultimately stand behind the large investment banks. This will irretrievably compromise market discipline, which in turn will produce the very risk-taking and subsequent losses that regulation—

as recently as the savings and loan debacle—has never been able to prevent.

The key question arising out of the Bear Stearns bailout is whether the surrounding crisis was a unique event or just the first of many similar crises resulting from a secular change in the market itself. If we are to make significant changes in policy, there should be substantial evidence that the financial market is materially different today than it has been in the past.

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But there is little evidence of this. In mid-March, when the bailout occurred, the financial markets were on the edge of chaos. This was—and in many respects still is—an unprecedented event. In the seventy years since the Great Depression, there has never been a crisis that the Fed could not address simply by flooding the market with liquidity. This crisis, however, was not a case of one institution's insolvency causing others to become temporarily illiquid; this was a case of the financial stability of virtually all the world's largest financial institutions being simultaneously in question. Ultimately, the Fed had to take credit risk on to its own balance sheet in order to stem the panic. In short, this unprecedented event should not be the basis for a major change in regulatory policy unless there is evidence that it will routinely recur in the future.

One reason frequently cited for viewing today's market as different is the advent of the credit default swap (CDS). These seemingly mysterious derivatives are said to make the market more "interconnected," so that the failure of a large investment bank might cause a systemic collapse. This is not correct. A CDS is like insurance or a performance bond; it moves risks by contract from one

place to another but does not create risks that did not already exist. Thus, even if a Bear Stearns failure had triggered obligations from those who had written CDS protection against a Bear default, the counterparties who were covered by this protection would have been relieved of a loss they would otherwise have suffered. The total amount of risk in the market is the same; it is just held by different institutions. To be sure, the unwinding in the Bear Stearns case would have been complicated, but that is a reason to set up a clearing house for swaps, not to regulate investment banks.

Moreover, unlike commercial banks, investment banks are unlikely candidates ever to cause systemic risk. Investment banks collateralize their borrowings. If they fail, their creditors can usually sell the collateral to make themselves whole. In contrast, the failure of a large commercial bank leaves its depositors and other creditors without funds until it is resolved. That is why large commercial banks, which have open account obligations to thousands of other banks, creditors, and counterparties, can be said to be too big to fail. Applying the too-big-to-fail label to investment banks reflects a serious misunderstanding of how their business model differs from that of a commercial bank.

In order to sign their agreement, the Fed and the SEC had to ignore a request by two powerful senators—Christopher Dodd (D-Conn.) and Richard Shelby (D-Ala.), the chairman and ranking member, respectively, of the Senate Committee on Banking, Housing, and Urban Affairs—who asked the two agencies in a letter last week to respect the prerogative of Congress to assign responsibilities to regulatory agencies. Instead, the two agencies have created a *fait accompli* that takes the question out of the hands of Congress. If Congress wants to have anything important to say about the regulation of the financial markets and the liabilities to be borne by the taxpayers, it should step in now to nullify this agreement or limit it to the emergency lending program the Fed began in March.

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# There Is No Reason to Panic

By Peter J. Wallison

If Fannie Mae and Freddie Mac were ordinary corporations, the sudden collapse of investor confidence last week would have set them to work on their bankruptcy applications. But they are not ordinary corporations—and they are likely to survive because their debt securities have been viewed for decades as ultimately backed by the U.S. government. Barring the unlikely event of a credit market loss of confidence in the U.S. government itself, they should be able to attract the necessary financing for continued operations.

The key judgment about their financial condition will not be made by the equity markets, but by their regulator, the Office of Federal Housing Enterprise Oversight (OFHEO). As long as OFHEO believes they are adequately capitalized—as James Lockhart, the director of the agency, affirmed in a public statement last week—they will continue to operate: buying, holding, and securitizing mortgages as they have for decades. And last night, the Treasury and the Federal Reserve announced they would take steps to prop up the two corporations if and as needed.

So there is no reason for stock market panic, nor for handwringing in the credit markets about an imminent default. Indeed, with the Senate finally—after months of dithering—passing legislation on July 11 for a strong new Fannie and Freddie regulator, there is hope that the government will finally be able to rein in the excesses of these enterprises.

Yet there is little evidence that the real lessons have sunk in. Just as the grave risks Fannie and Freddie create for taxpayers are finally being recognized, Fed chairman Ben Bernanke and Treasury secretary Henry Paulson were asking a seemingly compliant Congress to involve the Fed in supervising the largest investment banks—which will only create similar risks elsewhere in the economy. (More on this later.)

Although they are owned by shareholders, Fannie and Freddie are government-sponsored enterprises (GSE), chartered by Congress to perform a government mission: providing a national market for mortgages and enhancing the availability of affordable housing. This, together with a brace of special statutory exemptions and the fact that the U.S. government has always bailed out its GSEs, has led the capital markets to believe, correctly, that the U.S. government will never allow Fannie and Freddie to fail.

The result has been a complete loss of market discipline, uncontrolled growth, and the development of two giant companies whose deteriorated financial condition now threatens the stability of both the U.S. and the world economy. The story of Fannie and Freddie is a cautionary tale about the moral hazard created by government support for private institutions—a tale we saw played out in the savings and loan (S&L) debacle less than twenty years ago, and one we may be about to inflict on ourselves again.

There might have been a time when it was possible to believe that the feds would not stand behind Fannie and Freddie's obligations, but today, the possibility that any holder of their senior debt (or their mortgage-backed securities) would be allowed to suffer a loss is simply unimaginable.

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First, because of unprecedented conditions in the capital markets, they are now virtually the only consistent buyers and securitizers of U.S. mortgages. If they could no longer raise the necessary funds to continue this activity, housing finance—already very weak—would come to a halt. The consequences for the housing market in the United States would be dire.

The result of a GSE default for the financial markets and the world economy would, if anything, be even worse. Fannie and Freddie's debt securities are held by thousands of U.S. banks—often in amounts in excess of their capital—and in large amounts by financial institutions around the world. Many of the world's most important central banks also hold huge inventories of these securities.

If there were ever the slightest doubt that the United States would stand behind these obligations, there would be a rush for the exits that would make what occurred in the equity markets last week look like a stately minuet. The value of GSE debt securities would plummet, and with it the capital of virtually all the world's major banks

and other financial intermediaries. With weakened capital, lending would decline and further damage already weak economies, perhaps with truly disastrous results.

Thus, because the U.S. government will not allow Fannie and Freddie to default, they should be able to survive. If housing prices turn up again and their losses are stanching (or if they can raise more capital to cover the losses they will suffer in the future), these two companies will get through this period. This is by far the most likely outcome of the current period of stress.

But their survival will not be unalloyed good news. It will chase the wolf from the door only temporarily. Their embedded losses—made worse by the risky commitments they are probably now making in order to recover their profitability or hide their losses—will, as in the case of the S&Ls, eventually have to be paid. And, of course, if Fannie and Freddie actually become insolvent, the U.S. government is now ready to step up. Considering that these two companies now have something like \$5.3 trillion in liabilities, this is no small step.

This is a bad state of affairs; the U.S. government has lost any room to maneuver. Worse still are indications that no lessons have been learned. In the same week that it became apparent that implicit government backing has made the United States hostage to the health of two companies that grew out of control, Messrs. Bernanke and Paulson told Congress that they wanted a new regulatory structure for investment banks like Bear Stearns.

## The Perils of Paulson

By Vincent R. Reinhart

The chief stewards of U.S. financial market policies seem to be living out an old-time movie serial. Over the past year, Treasury secretary Henry Paulson and Federal Reserve chairman Ben Bernanke have moved from crisis to crisis, improvising as they go. The distressed damsels they saved over the weekend were the government-sponsored mortgage giants Fannie Mae and Freddie Mac.

Part of creative policymaking, as in moviemaking, is obscuring the moving parts. But it is clear even now that over the weekend the government safety net was significantly expanded, the lines between the public and private sectors were further blurred, and the odds were raised that such government rescues will be needed in the future.

Fannie and Freddie, as government-sponsored enterprises, are public-private entities with special advantages

to foster housing finance. Those advantages include a backup line of credit with the Treasury, exemption from some securities registration requirements, and the designation of their debt as “government securities.” The whole package combines to confer a huge perk: investors believe that the firms’ debt is implicitly guaranteed by the government. Thus, the debt that Fannie and Freddie sell commands a yield close to those on Treasury securities, and they need not hold as much capital as other firms are required to. This gives them a significant leg up on their competitors.

In this plan, the Fed would have supervisory authority over these companies and oversee a formal system for their “orderly liquidation.” The only reason the Fed might want to regulate the investment banks is that it believes itself to be somehow at risk. The markets, ever clear-eyed, will read this for what it is—potential Fed backing if the big investment banks get into trouble. In other words, we are now proposing to introduce a government-created moral hazard into investment banking. The resulting loss of market discipline will replicate the experience with the S&Ls and Fannie and Freddie.

According to reports, no one blinked an eye in the House Financial Services Committee when the Fed’s bid for more power was laid on the table July 10. This is fully consistent with the past willingness of Congress to condone—and even encourage—unimpeded growth at Fannie and Freddie.

If Congress actually believes that the Fed can assume responsibility for supervising and liquidating the large investment banks—and yet not become responsible for bailing them out when their enhanced access to capital results in massive losses—they deserve to wrestle with the future crisis they are now setting in motion. But the American people do not.

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Investors have recently become concerned about what would happen if the implicit guarantee were tested. If markets turned against Fannie and Freddie, would all securities be backstopped by the government? Would the

interests of existing shareholders be diluted? As worries have spread, Fannie and Freddie's reception in funding markets has chilled and their share prices have plummeted.

These concerns set policymakers in motion. The government has essentially built two bridges for these institutions. In the very near term, the Federal Reserve has granted them access to its discount window.

The Fed bridge is set to shut down when the Treasury link opens. This requires Congress to expand the Treasury's authority to lend and to allow the purchase of preferred stock. The Treasury would be providing longer-term funding, presumably giving the entities time to shore up their balance sheets by raising more capital.

The argument is that if the government opens its checkbook to these firms, private investors will be less likely to flee.

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Indeed, if investors become sufficiently confident, the crisis could fade without the government's lines being tapped at all. Yet there are two reasons to doubt that this movie ends so happily and two reasons to wish it were never made.

First, in the near term, continued double-digit declines in housing prices will raise doubts about the repayment prospects of more and more mortgages. Add to that the difficulties associated with an economy teetering on the brink of recession. Anyone holding mortgages or mortgage-related securities is in for a bumpy ride. Fannie and Freddie, which are exposed to more than half the market, are sure to face large losses and squalls of investor uncertainty.

Thus the second problem: the endgame is uncertain.

The government's funding responsibility will end only when the two firms have raised sufficient capital. It will be impossible for the Fed or the Treasury to turn away a request for more credit. The overall provision of credit could, therefore, be sizable and extended.

While policymakers have at least temporarily resolved this crisis, we will live with the consequences for a long time. Consider the downsides.

First, the Federal Reserve is likely to be given additional responsibilities related to overseeing housing finance. What happens when that goal interferes with the ones Congress has already given it—fostering maximum employment and stable prices? An overextended Fed might be tempted to keep the liquidity tap open too long to support housing finance, even at the cost of a pickup in inflation.

Second, the government had to act because, in today's interconnected markets, Fannie and Freddie are too big to be allowed to fail. Policymakers missed an opportunity for significant reform.

The public-private mix embodied in the government-sponsored enterprises has been shown once again not to work. The public aspect lulls investors into complacency, while the firms' private management will always try to keep their capital reserves as low as possible, potentially endangering the companies' solvency.

Policymakers could have used the crisis to focus attention on the entities' appropriate long-term status. The government could have privatized them completely by severing the implicit guarantee or nationalized them by allowing their equity to go to zero, as the market was headed. (My preference is the former, but even the latter has advantages over what policymakers did.) Instead, our nation is now reaffirming a model that does not work, almost guaranteeing a repetition of this problem down the road.

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