

Improving the Financial System for the Next Cycle

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Asset bubbles inflate because enough people believe that the good times of expanding credit and rising asset prices will last forever, but of course they don't. In the midst of the bust that follows, it seems that the bad times of defaults, scarce credit and falling prices will last forever, but of course they won't.

I don't believe financial cycles can be avoided any more than business cycles can. We are still vastly better off with functioning markets, for all their boom and bust cycles, than with socialist stagnation.

"Our regulatory system has failed miserably, and we must rebuild it," Congressman Paul Kanjorski said recently. After every bust, politicians enact new regulations and reorganize regulatory agencies. This is to make sure, they say, that the problems "will never happen again." In time, they happen again anyway. In 1914, the then Comptroller of the Currency pronounced that with the new Federal Reserve Act, "financial and commercial crises or panics seem to be mathematically impossible." They weren't.

This is not to say there are not ways to improve the financial system, and mortgage finance in particular. Here are six suggestions, which in my view are much more important than reorganizing regulatory bureaucracies:

1. Countercyclical LTVs. Leverage at the mortgage borrower level is expressed as the Loan-to-Value ratio or "LTV." An LTV of 80% means the homebuyer has borrowed 80% of the price of the house, and made a down payment out of savings of 20%. An LTV of 100%, not uncommon during the housing bubble, means the buyer has borrowed all the money and made no equity commitment. Did it make sense to make these loans? No, but it seemed like a good idea if you believed house prices would always go up.

There is a strong and reliable statistical relationship between LTVs and mortgage defaults. Not surprisingly, the higher the LTV, the higher the defaults. When the house price declines, the LTV automatically increases.

In a housing boom, as house prices rapidly inflate, the risk that they will subsequently fall is increasing. So in a rational system, LTVs would be lowered as house prices accelerate over their trend. What in fact happens in the boom is that as rising prices induce optimism in both lenders and borrowers, LTVs tend to rise, up to and including 100%: exactly the opposite of what should happen.

Reversing this perverse LTV behavior would make for a much sounder housing finance system.

2. Old-Fashioned Loss Reserves. We should return to the old-fashioned idea of building loan

loss reserves in good times. As an old banker told me long ago, "Bad loans are made in good times." This is just the time to be building reserves against the inevitable vicissitudes of any firm bearing credit risk.

Spain, now involved in its own housing bust, is glad that in 2000, it forced its banks to begin a system of countercyclical "dynamic provisioning," building up reserves far beyond current losses to prepare for possible future losses. This system, old fashioned as it is, is becoming the international model.

Unfortunately, in this country the SEC went in just the opposite direction from what the Spanish regulators did. It actively opposed building large loan loss reserves, because it regarded them as undesirable "earnings management," which would understate profits in good times, while providing a cushion for bad years. The result was to overstate profits in the bubble and to have insufficient cushion in the bust.

The reality of all businesses built on credit risk is that they experience, on a cyclical basis, periods of high losses, often far beyond expectations -- like now. If you don't reserve against this reality, you create, as American official accounting did, illusory profits in the good times. These in turn trigger bonuses and also induce financial firms to reduce equity through buybacks of their shares. Alternately stated, in the good times financial firms book what are really insurance premiums for bearing risk instead as profit in advance, while the risk builds without prudent enough reserves. This is obvious, now that the risk has come home to roost.

3. Risk Retention in Securitization. We should combine mortgage securitization with credit risk retention by the mortgage originators who perform the credit underwriting and make the credit decisions.

A prime lesson of the 1980s savings and loan collapse was that for financial institutions to keep long-term fixed rate mortgages on their own balance sheets was extremely dangerous in terms of interest rate risk, although it was not a problem in terms of credit risk. The answer was to sell the loans to bond investors through securitization and divest the interest rate risk to those better able to bear it. As a side effect, the credit risk was also divested.

In the wake of the mortgage bubble and bust, everybody now realizes that divesting mortgage credit risk created huge problems of its own, breaking the alignment of incentives between the lender making the credit decision and the ultimate investor actually bearing the credit risk. Some commentators have referred to the good old days when the savings and loans kept the loans themselves -- displaying notably short memories.

The right synthesis of the historical lessons is for securitization to continue to address interest rate risk, while simultaneously encouraging retention of significant credit risk by the original mortgage lender. The superiority of this combination makes it well worthwhile to try to overcome the regulatory and accounting obstacles involved.

4. Remove Government Sponsorship of Rating Agencies. The credit rating agencies say that they are in the business of publishing opinions about the future. In this I believe they are right,

and in the course of financial events, inevitably some such opinions will prove to have been mistaken, even disastrously mistaken. So when it comes to opinions about the future, more opinions and competition is likely to uncover new insights into credit risks and new methods of analysis.

A particularly desirable form of increased competition would be from ratings agencies paid solely by investors, as opposed to those paid for by the issuers of securities.

Moreover, since all opinions are liable to error, and opinions based on models are liable to systemic error of vast proportions -- as the subprime bust makes apparent -- why should the U.S. government enshrine certain opinions as having preferred, preferential, indeed mandatory, status? It shouldn't. Government sponsorship makes the rating agencies a concentrated point of potential failure, which in the subprime mortgage collapse, indeed failed.

All regulatory requirements to use the ratings of certain preferred rating agencies should be eliminated. Banks and other regulated investors should instead be responsible for developing their own prudent standards, which would probably entail the use of credit ratings as part of a credit management system -- but without government sponsorship of any ratings firms.

5. Drop the Government's "Confidence" Slogan. A constant theme in public statements is that the government needs to promote "investor confidence." This is simply assumed to be a good thing, but it isn't. Every professional investor knows the key investing virtue is not confidence, but its opposite: skepticism. The right idea is for the public, faced with financial stories, investment advice, earnings releases, Wall Street pontifications, and official government assurances, never to let their skepticism slip.

6. Study Financial History. Why do financial crises and busts keep happening? Why don't we learn from the numerous blunders of times past?

"The mistakes of a sanguine manager are far more to be dreaded than the theft of a dishonest manager," wrote the celebrated banking thinker, Walter Bagehot. The best protection against deceptively sanguine beliefs is the study of financial history, with its many examples of how easy it is to be plausible, but catastrophically wrong, both as financial actors and as policy makers. We need a required course in the recurring bubbles, busts, foibles and disasters of financial history for anyone to qualify as a government financial official or as a manager of any financial firm.

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