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Financial Crisis Symposium

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RUTGERS JOURNAL OF LAW & PUBLIC POLICY: FINANCIAL CRISIS SYMPOSIUM

MODERATOR: Good afternoon. My name is Donald Benedetto, chapter president of the Federalist Society at Rutgers University School of Law at Camden, and on behalf of the Society, let me welcome you to our symposium discussing the ongoing financial crisis in cooperation with the Rutgers Journal of Law and Public Policy. The Federalist Society for Law and Public Policy Studies is a group of conservatives and libertarians interested in the current state of the legal order. It is founded on the principles that the state exists to preserve freedom, that the separation of government powers is essential to our Constitution, and that it is emphatically the province and duty of the judiciary to say what the law is, not what it should be. The Society seeks to both promote an awareness of these principles and to further their application through activities such as today's event.

Just a brief note on the format: Each participant is going to deliver a statement on his assessment of the current situation, and then the other participant will give a rebuttal. After that, our panelists will engage in a discussion, followed by questions with both participants commenting on the other's answer.

I'd like to now introduce our participants. First, from the faculty here at Rutgers University School of Law, is Professor Arthur Laby. For those of you who don't know Professor Laby, he teaches classes in securities regulation and business organizations. His research focus is on fiduciary relationships, conflicts of interest, corporate governance, and securities enforcement. Professor Laby is currently working on a project that applies lessons from behavioral finance to insider trading, and a second project on why foreign companies list their shares

in the United States. Before joining the faculty, Professor Laby served for nearly ten years on the staff of the United States Securities and Exchange Commission, and most recently as Assistant General Counsel.

Our second participant, visiting us today, is Mr. Peter Wallison. Mr. Wallison holds the Arthur F. Burns Chair in Financial Policy Studies, and is the Co-Director of the American Enterprise Institute's program on Financial Markets Deregulation. Prior to joining AEI, he practiced banking, corporate, and financial law at Gibson, Dunn & Crutcher in Washington, DC and New York. Mr. Wallison has held a number of government positions. From June 1981 to January 1985 he was General Counsel of the United States Treasury Department where he had a significant role in the development of the Reagan Administration's proposal for the deregulation of the financial services industry. He also served as General Counsel to the Depository Institution's Deregulation Committee, and participated in the Treasury's Department's efforts to deal with the debt held by less developed countries. During 1986 to 1987, Mr. Wallison was White House Counsel to President Ronald Reagan. Between 1972 and 1976, Mr. Wallison served first as Special Assistant to New York Governor Nelson A. Rockefeller, and subsequently as counsel to Mr. Rockefeller when he was Vice President of the United States. He's a frequent contributor to the op-ed pages of *The New York Times*, *The Wall Street Journal*, and *Financial Times*, as well as the author of numerous books, including most recently, *Competitive Equity: A Better Way to Organize Mutual Funds*. Mr. Wallison is also a member of the Shadow Financial Regulatory Committee, and the Council on Foreign Relations. We're fortunate to have both gentlemen participating, and thank you, Mr. Wallison, for coming to visit us today, and I'll turn it over to you. [Applause]

PETER WALLISON: Thanks very much, Don, and thank you to the Federalist Society for organizing this program, and inviting me. And I'm also delighted to have an opportunity to be on the same panel with Arthur Laby, whose work in the securities world is known to me, and known to many others, and should provide, I think, a very stimulating discussion after each of us gives our initial presentations. Mine is going to be about how we got here--how we got into this incredible

financial crisis, something that is quite close to the Great Depression. We have not seen the bottom yet. If you've looked at today's papers, there's still tremendous concern about the health of the banking system, and maybe during the discussion we can get into why this is true, what might be done about it, what has been done, and why that has not been satisfactory. But let me go into my analysis of how we got here.

Everyone has heard about the housing bubble--that is, a huge inflation in the value of homes – but that alone is not the cause of the housing and financial crisis that we have today. The real cause is not just the inflated home prices, but the poor quality of the mortgages that are now on bank balance sheets. So, one of the things I'm going to talk about is how those poor quality mortgages got there, and why. In this connection, I'll talk about the Community Reinvestment Act, Fannie Mae, and Freddie Mac, non-recourse loans, re-financings without penalty, home equity loans, and bank capital regulations. All of those things in my view contributed to the problem we have today in major ways.

Fannie Mae and Freddie Mac are two government sponsored enterprises or GSEs. Together with the Community Reinvestment Act (CRA), they are the source of the financial problem we face today. The policy underlying the GSEs and the CRA was to increase homeownership in the United States. But it was not done the way Congress usually does things. In the usual case, Congress adopts a policy of some kind, and to implement it, it also adopts a subsidy program. There are a lot of benefits that come from home ownership. We ought to have policies in this country which encourage more people to own homes. It has many good effects on families and on delinquency, and a lot of other things that benefit society. But in this case Congress did not appropriate any funds; it simply required banks under the CRA, and Fannie and Freddie, to make mortgage loans to people who could not otherwise afford to buy homes.

The result of this policy has been to distort the way the system would normally work. Fannie and Freddie were originally chartered by Congress to buy mortgages from banks and from other lenders, to create a liquid secondary mortgage market.

They either hold these mortgages on their balance sheets, and receive the income and the principal on the mortgages, or they create mortgage-backed securities, which they sell to investors. They guarantee that the mortgage-backed securities will pay a certain return to all investors. Together, they have about $5.3 trillion in mortgages and guarantees of mortgage-backed securities on their balance sheets.

In 1992, Congress gave Fannie and Freddie a mission to promote affordable housing, to make home financing available to people who otherwise were not able to get mortgage loans. The agency that was to regulate them, the Department of Housing and Urban Development, then developed a set of regulations that required Fannie and Freddie's purchases of mortgages to include a certain percentage of low and moderate income housing loans. By 2005, that percentage was 55 percent, which had to include at least 25 percent that were made to low- and very low-income borrowers.

Now, the trouble with this requirement is that it is very difficult to make a loan to a person who has not had a mortgage before, or doesn't have the income to buy a home, or support a mortgage, unless you vary the terms in substantial ways. One of the principal ways to do this is to reduce the amount of the down payment, which means that there is a very high loan-to-value ratio. So, if the price of the home is $100,000, and you only have to put up $5,000, the loan-to-value ratio is 95 percent. That's one of the ways that it became possible to provide homes for people who otherwise were not able to buy them, but what that means is that the banks were going to have to take much more risk. The Affordable Housing Regulations from HUD went into effect for Fannie and Freddie in 1993, and new and tougher regulations under the Community Reinvestment Act, which required banks to make loans to everyone in their community area, no matter what their financial capabilities, went into effect in about 1995. The policy actually did work, because home ownership rates started to rise sharply in 1995.

Home ownership rates had been about 64 percent for at least ten years before that, and not much different from that for about 25 years, but they began to move up in 1995. By the end

of the Clinton Administration in 2000 home ownership was at 67.5 percent, and they reached a high of 69.2 percent in the Bush Administration, before falling back a little bit in 2007 to about 67.7 percent, if I remember correctly. So, we did actually have a substantial increase in home ownership, and the reason was that people were now able to buy homes who couldn't buy them before, because the standards for the loans were much tougher in earlier periods.

The trouble is, that in order to meet their affordable housing requirements Fannie and Freddie bought many substandard loans. Between 2005 and 2007, they bought over $1 trillion in subprime and other weak loans called Alt-A loans. This amounted to about 40 percent of their purchases during this period.

A subprime loan would be one made to a borrower who has a very low credit score; a FICO 660 credit score is the dividing line between a good loan and a subprime loan. Anything above 660 is considered a prime loan; anything below 660 is considered a subprime loan. Fannie and Freddie purchased large numbers of subprime loans in order to comply with the HUD regulations. An Alt-A loan is a loan that has many other kinds of deficiencies. It might not have any amortization of principal at all. It might be an interest only loan. It might have negative amortization. But mostly it has a very, very low down payment. By 1997, Fannie was offering a mortgage with a 97 percent loan-to-value ratio--that is a 3 percent down payment--and by 2001 Fannie was offering a loan that had no down payment at all. In other words, it was a 100 percent loan based on the price of the house.

Why did they purchase over $1 trillion in subprime and Alt-A loans between 2005 and 2007? It's very hard to understand their motivation, but I think there is one possible reason. In 2003 and 2004, Fannie Mae and Freddie Mac had some very serious accounting problems. Both of them were found to have done essentially what Enron and WorldCom had done: they had manipulated their financial statements in order to make themselves look more profitable, and provide opportunities for their managements to get bonuses. Eventually, they had to restate their financial statements, and this caused them to lose

some of the support that they had in Congress. They were regulated for safety and soundness by an agency called the Office of Federal Housing Enterprise Oversight, but the regulation was extremely weak. They were worried, after 2003 and 2004, that they were going to have to face much tougher regulation, which might make them much less profitable.

So, beginning in late 2004, in my view, they decided to buy many, many more affordable housing loans than they were required to buy, in order to curry favor with Congress. Their supporters in Congress were pleased with this. But no one in Congress was actually thinking about what this meant for Fannie and Freddie's obligations, and what the taxpayers ultimately would have to pick up. Fannie and Freddie's very large purchases also started a frenzy for subprime and Alt-A loans. By 2006, almost half of all mortgages that originated in the United States were subprime or Alt-A mortgages--mortgages that were very risky for Fannie and Freddie and for the banks that ultimately bought and held them.

There were other important factors that contributed to the current financial problem. It wasn't just that bad mortgages were being made in vast numbers. In addition, as you may know, homeowners are allowed to refinance their mortgages without any penalty. When interest rates fall, a homeowner can refinance his mortgage in order to reduce the monthly payment on the house. Many homeowners used this provision to take cash out of the equity in their homes by borrowing an amount larger than the principal owed on the mortgage. In this way, $386 billion in equity was taken out of these homes just in the year 2006. The cash could be used to buy a boat, another home, take a vacation, or anything else. Also, interest on home equity loans is tax-deductible in the United States, so it is possible for a person to borrow on the equity of his or her home, pay off credit card debt, pay off ordinary consumer loans, or pay off car loans. So a homeowner can pay off other consumer loans with loans on the equity of his home, and deduct the interest on the home equity loan. That, of course, drew out much more equity from homes in the United States.

In addition, US laws permit non-recourse mortgages, which means that the homeowner has no personal liability on the

mortgage note. So, if a person can no longer meet his mortgage obligations it's possible just to walk away from the home. The bank's only recourse is to sell the house. So many people are simply walking away from their mortgages, because either they signed up for mortgages that they couldn't pay, or the value of the home has fallen so much that they don't think it's worth holding onto the home anymore.

And finally, bank regulations permit banks to reduce the capital they hold behind mortgages. Under international capital regulations, banks must hold about 8 percent capital behind every commercial loan, and 4 percent behind any mortgage, but if a bank turns those mortgages into mortgage-backed securities, it only has to hold 1.6 percent capital against the asset. So, many banks took their mortgages, put them into a pool, and took back securities backed by the pool of mortgages. This turned their mortgage portfolio into a portfolio of mortgage-backed securities, substantially reducing the capital they had behind those mortgages. Now, when the mortgages decline in value, there isn't much capital in the banks to back them up. And since people have drawn so much of the equity out of their homes, when their homes decline in value, there isn't much equity in the homes to keep people in them.

So, as a result of all of these policies – CRA, Fannie and Freddie and the various other policies I have described, there are the makings of a very substantial financial problem. As mortgages decline in value, homeowners are leaving their homes and the banks have very little equity, very little capital to protect themselves. Many are now in serious trouble. If Fannie and Freddie had not made so many subprime and Alt-A loans, and stimulated a boom in these loans between 2005 and 2007, then I think the chances were small that we would have the kind of problem we have today.

So, here's a summary of what has happened. There are now 25 million subprime and Alt-A loans outstanding. That's over 40 percent of the total amount of all loans outstanding on homes in the United States. The total unpaid principal balance is something over $4 trillion. Fannie and Freddie hold or have guaranteed $1.6 trillion, which is about 40 percent of their

balance sheets. These loans are defaulting at unprecedented rates, and that is before the resets on loans that were initially made with teaser rates that were to reset after a couple of years. When those resets occur, in 2009 and 2010, they will cause many, many more defaults. That's one of the reasons why you read in the newspapers that the banks are in such serious trouble, and we are not near the end of the problem yet. So, the outlook for our economy is not good, at least if we are hoping for the banks to be healthy enough to make loans of all kinds to businesses and to individuals. That will not happen for a long time, until the banks are able to overcome the serious problem of weak mortgages. Thanks very much. [Applause]

ARTHUR LABY: Hi, everybody. I first want to thank the Federalist Society for hosting this event. Thanks to Don and to Tyler for helping with the organization, and most of all, thank you, Peter, for agreeing to come here and talk about this. We really appreciate it.

PETER WALLISON: Thank you.

ARTHUR LABY: Peter talked a lot about the federal government's responsibility for the crisis, and I think the first thing we want to do is step back and take stock of the severity of the crisis itself. What is this economic crisis? This is really an international crisis of very significant proportions. Just in the past 18 months – 12 or 18 months – we've seen the bankruptcy or equivalent of Fannie Mae and Freddie Mac, the failure of two very large investment banks – Lehman and Bear Stearns – and other banks have suffered as well; we have witnessed the near failure of AIG, the large insurance company, and the venerable Merrill Lynch, the big brokerage firm, was essentially taken over by Bank of America. We've seen problems not only in the US, but also in Europe. This includes a run on Northern Rock in the UK, problems in Switzerland, and other problems throughout Europe. This is such a huge crisis that it's difficult to say there is any single cause, like US government policy, that's responsible. Rather, a series of both private and public sector actors are to blame.

When we say we want to understand the crisis, what does that mean? To understand the crisis means to first understand its

root causes: How did we get here, as Peter asked? To understand the causes of the crisis we need to unpack a bit about the financial products involved, and that means understanding not only the mechanics of the products, but how they were marketed and sold. Once we understand how the products were marketed and sold, we can understand the role of some of the so-called gatekeepers – those persons and firms that should have been looking for problems along the way but didn't necessarily do their jobs. I want to give one caveat: This must be a selective overview. There is no way we can address the entirety of the crisis in a 15- or 20-minute presentation.

For purposes of today's discussion, the history of this crisis begins around the year 2000, although we could take it back much farther. Around 2000 we saw a significant amount of money available for investment. This came about for several reasons: Certain emerging markets had significant reserves available after the Asian financial crisis. They didn't want to be caught flat-footed as they were in the late 1990s. In addition, there was a lot of new wealth in countries like China, India, and Saudi Arabia. When National Public Radio reported on this situation, the reporters referred to the global pool of money, which was a helpful phrase. They said that it grew from something like $35 trillion around 2000 to some $70 trillion several years ago.

Also around the same time, we saw the federal government keeping interest rates quite low – the federal funds rate, which is the rate banks charge each other on loans, was hovering around 1 or 2 percent from 2001 to around 2005. That's a low rate. People who are looking for a place to invest are not going to invest in Treasuries. Interest rates are too low. One possibility, therefore, is to invest in residential mortgages. Residential mortgages are typically safe. They pay a decent rate of return – 5, 6, or 7 percent-- but there's a problem when a big institution wants to invest in residential mortgages. Consider what a conventional mortgage is and how it operates. In a conventional mortgage, the bank lends money to the homeowner; the homeowner promises to pay back the loan in 15 or 30 years; and the bank takes a security interest in the property. It's a very simple arrangement. The problem is a large investor doesn't want to buy individual mortgages. That's silly. First of all,

they're too small. The institution would have to buy hundreds or possibly thousands of these mortgages to make it worth its while. Second, they're too burdensome. The large financial institution doesn't want to have to go to the bank each month and deposit checks, monitor who pays, and decide when to foreclose; that's too much of a hassle. So, what happened? The solution came in a financial product called "mortgage-backed securities," which Peter mentioned in his presentation. To understand the credit crisis, we need to dig into the mechanics slightly and understand how mortgage-backed securities work.

What are mortgage-backed securities? They're really not very complicated. Anybody who's had my [Business Organizations] class knows that if you draw a picture, it makes life much easier. [Laughter] A bank or a broker – these firms on the left of the picture – they sell mortgages, not one, but usually many mortgages to an entity – to a pool of mortgages, that is organized, generally, by an investment bank, and very often in private deals. Often there is no involvement by Fannie Mae or Freddie Mac. These are private arrangements. Now the pool has to raise money in order to pay for these mortgages. They're buying them from the banks and the mortgage brokers. They raise the money by issuing a security to investors, a mortgage-backed security. These mortgage-backed securities are then sold in different slices, or what are called tranches, depending on the priority of payment. If you're somebody who seeks a very safe investment, then you're going to buy that A-tranche. You're going to get an investment grade security; it's going to pay a lower rate of interest, but you're safe. If anybody is not paid, it's not going to be you. If you're willing to take on more risk, you might buy the B-tranche. You will still probably be paid, but the risk of default is higher, and the rate of return you will receive will be higher too. If you're willing to take on substantial risk, but you want a higher rate of return, you might invest in that C-tranche. In that case, if there are some borrowers who default on their mortgages, and the pool doesn't have enough money to pay out, you're going to be the person who is not paid back in full.

That's the way these mortgage-backed securities work. Generally, they're quite useful. They allow investors to diversify risk – diversify default risk. If you are an institution, and you bought a single mortgage, there's a chance you would lose your

investment. These instruments allow diversification, and allow investors to tailor the risk that they want based on the tranche that they buy. Already we can see that there's a danger in these mortgage-backed securities. It should be clear that the lenders or brokers, once they sell that note, once they sell that mortgage to the pool, they no longer have to worry about the creditworthiness of the borrower. They're done with the deal. It's off their books. They've sold the mortgage to the pool and received their money. They're through with the arrangement, and we'll come back to this in a few minutes because it's the basis for one of the problems that we've seen.

How are these mortgage-backed securities sold? How could the investment banks sell the lower tranches in particular? Who would want to buy that stuff? First, some of the lower tranches were actually kept on the books in the investment banks, and this is one of the reasons we've seen significant writedowns – losses by some of the larger banks in the tens of billions of dollars. In other cases they were sold to high-risk investors. In still other cases, the banks were able to obtain insurance – portfolio insurance to guarantee the riskier tranches. Some insurance companies were willing to insure those securities against default. We know in retrospect that in some cases, there wasn't enough money in the insurance companies to actually make good on that promise, and some have now gone out of business.

Another way that the mortgage-backed securities were marketed was through high ratings by the credit rating agencies. The rating agencies in some cases rated the securities too highly. Why would they do that? Many argue the rating agencies suffered from conflicts of interest. Their customers were the banks: They were paid by the very people whose products they were rating and they had an incentive to rate too highly. In some cases the ratings apparently were negotiated. The rating agencies worked together with the bank whose securities they were rating to come up with a rating that was suitable to the bank. The bank would desire a particular rating and, in order to qualify, the rating agency might request a change in structure or the purchase of insurance. The rating at the end of the day would be a negotiated document. It's clear now that the rating agencies did not adequately assess the risk of failure. As one

example, Standard & Poor's, one of the big rating agencies, revised many of their ratings; they placed some 69 or 70 percent of formerly triple A-rated subprime bonds on what they call "a negative watch," which means that they're quite risky. We now know that in many cases the rating agencies – one of the so-called gatekeepers in the process -- were falling down on the job.

Another technique used by the investment banks to sell the lower tranches was through a process called "resecuritization." Now, what does that mean? You have to suffer through one more difficult slide. [Laughter] What is resecuritization? I am oversimplifying a bit, but an investment bank might buy the B tranches from other mortgage-backed securities, create another pool, a second pool, and reissue another security, a second security, out of the pool of the other B tranches that are now together in the new pool in the center. When they issue this security, we again have three levels of priority – A, B, and C. So, we're back to the place where we were before. The A-tranche, the first priority, will get a higher rating – in some cases a double A or triple A rating; the B will get a lower rating, and the C will get a lower rating still. Through the process of resecuritization, some of the large banks could more easily sell the lower tranches.

As a result of these financial products and other developments, there was great demand for mortgages. Mortgage-backed securities were incredibly popular. They were doing well. Everybody wanted to buy them. And if you're going to issue a mortgage-backed security, you need mortgages. You need lots and lots of mortgages to pool and create the instrument.

Another reason for demand was, as Peter mentioned, that around the year 2000, HUD increased the requirements for Fannie and Freddie to buy loans made by lower income borrowers. We can talk more about this in the discussion. I'm more skeptical about this explanation than Peter for a couple of reasons. My understanding is that in the case of HUD, an increase in requirements occurred around 2000, but the real bump-up in purchases didn't come until 2004 or 2005, so it's not necessarily the case that the change in Fannie and Freddie buying the loans was due to HUD policy. I've also seen statistics indicating that in many of these cases, Fannie and Freddie

would have bought these loans anyway, regardless of HUD policy. In other words, 97 or 98 percent of the loans would have been purchased regardless of HUD. We can put that aside for the time being.

What were the consequences of this increased demand for mortgages? A few things. Mortgage brokers now had an incentive to create mortgages in large quantities. Again, recall the problem mentioned earlier. Once the mortgage brokers create the mortgage and sell it to the investment bank, they're no longer concerned about the creditworthiness of the buyer. The professionals who should be acting as the gatekeepers, ensuring that the borrower can afford the mortgage, no longer have an incentive to worry about creditworthiness. They sell the loan and it is off their books.

In addition, during this time, underwriting standards became more permissive. Some lenders stopped requiring W-2s and no longer required verification of employment. In other cases, lenders would want to see some assets, but did not worry about income. Some banks even made loans without looking at any income or assets. These were so-called no income, no asset – NINA – loans. Mortgage products were developed that were quite unsafe for borrowers. One example is the option adjustable rate mortgage. In that case, the borrower agreed to defer partial payment on a mortgage for months or in some cases years. It sounds good at first but, needless to say, when the mortgage comes due in full, the borrower may be unable to pay and forced to default.

Appraisers were also responsible. We know in retrospect that certain appraisers inflated the values of homes they were appraising. Why? Because they only were paid if the deal goes through. If the lender sends an appraiser to your home to make sure the home is worth a certain value, that appraiser knows that it isn't going to get repeat business by the same bank unless it can come up with an appraisal high enough to allow the deal to proceed.

Finally, the borrowers themselves are not blameless. Although there were cases of actual fraud, where mortgage brokers simply lied about the amount or timing of payments, actual fraud

probably occurred in a relatively small number of cases. Borrowers were willing participants in this as well. Self-restraint is difficult. It's easy to jump into a mortgage and buy a home that might cost $700,000 or $800,000 when you can only afford a home selling for half or a third that value.

The demand for mortgages led to a housing bubble. From 2003 to 2006 loans were a lot easier to get. Housing prices jumped substantially. Historically, housing prices were roughly two and a half times families' annual income. They jumped to around four or five times families' annual income, and it wasn't only in the US, which again, is not consistent with the thesis that US government policy is to blame. Prices rose in the UK, Spain, Australia, and other countries where the standards were relaxed.

Why were there not more defaults during this period? In some cases, and Peter alluded to this, the borrowers were able to use rising home prices as collateral to take out second and, in some cases, third mortgages. This has some shadows of the Bernard Madoff Ponzi scheme. The home owner could essentially borrow from a second lender to pay off the first. Second, of course, the defaults came, and they came in large numbers. They started in late 2006, and continued in early 2007. More homes became available. There were fewer buyers. Prices started dropping, and eventually the housing bubble burst.

How did we move from a housing crisis to a financial crisis? We've talked a lot about mortgage-backed securities and the housing crisis, but we know that the financial crisis is much broader. The stock market is down. Banks are failing. The whole economy is in trouble. How did this happen? Again, this is a very complicated topic. I don't pretend to be able to explain all or even some of it comprehensively in 15 or 20 minutes, but one answer to that question is that the system is interconnected, and the failure of one sector, like the housing sector, ripples through the economy causing lending to freeze up. If lending freezes up, it becomes difficult for companies to operate. But why would a housing crisis cause lending to freeze up? What's the connection?

Let me give one example of the way this might work, and again, this is not the sole explanation of the phenomenon. I want to

give one example to illustrate the way the system is interconnected. In order to do that, we need to delve into the esoteric topic of money market funds, and something called "commercial paper." So, bear with me for another few minutes.

Most of you probably know what money market funds are. They are a type of investment offered by financial firms, such as Fidelity, T. Rowe Price, and Putnam, and they're very safe. They're priced at $1.00 per share and they offer a very low rate of return, but they're incredibly safe investments. They invest in conservative instruments, such as US Treasuries, high quality bonds, and something called the "commercial paper market." What is the commercial paper market? Commercial paper is just a fancy word to describe short-term loans that companies take out every week to operate their business and pay their bills. Companies often are short on funds one week and long on funds another week. They often need to go into the commercial paper market and borrow $1 billion here, $1 billion there. The sums are quite vast; they're quite huge, but this is boring stuff. Nobody is interested in this market because it's only the larger, safer companies that participate and the transactions occur every day of the week.

What happened a few months ago in the commercial paper market? One particular fund called the Reserve Primary Fund with about $62 billion in assets loaned a lot of money to Lehman Brothers in the commercial paper market. Like other firms, Lehman borrowed all the time. The Reserve Primary Fund agreed to loan Lehman money. This is usually only a 30- or 45-day loan, sometimes shorter.

We now know that Lehman had significant exposure to mortgage loans. Lehman Brothers failed in September of 2008 and its failure caused significant losses in this Reserve Primary Fund. The Fund loaned a lot of money to Lehman Brothers, which all of a sudden became insolvent, and could not pay back the Reserve Primary Fund the money that was owed. The Fund lost a lot of money. In addition, this loss precipitated requests for redemptions by investors. If you invested $1,000 in the Reserve Primary Fund, you might ask to redeem your shares. "I want my money back. I'm concerned about you." The Fund, however, couldn't handle these requests for redemptions. It lost

too much as a result of the investment in Lehman. As a result, the Reserve Primary Fund "broke the buck." The value of the Fund, which again, should always be set at $1.00, dropped below $1.00. Remember, in a money market fund you generally invest $100 and you receive 100 shares. A year later you may only get 102 shares back – a 2 percent rate of return – but it's a safe investment. The Reserve Primary Fund couldn't manage that. It broke the buck. The value of the fund dropped below $1.00. That's the equivalent to a mid-air collision in the world of money market funds. They very seldom go below $1.00. It's happened a handful of times in the history of money market funds.

That was a signal event. As you can imagine, other money market funds were quite worried about this, and they too determined to slow their lending in the commercial paper market. That caused, at least for a week or two, a significant freezing up of the credit markets. What happens when companies can't borrow money? Exhibit one is – who just filed for bankruptcy?

AUDIENCE: Circuit City.

ARTHUR LABY: Circuit City – I'm not suggesting it was exactly the same, but Circuit City had trouble obtaining short-term financing. They're now in bankruptcy; 30,000 people are now out of work as a result. These developments ripple through the economy. More unemployment means lower amounts of purchasing power by people who were previously employed, and the process continues to spiral downward. This isn't the sole explanation of the broader financial crisis, but when there is a freezing up of the credit markets, and companies are unable to borrow, lots of companies postpone investing, and some go into bankruptcy.

We've seen significant losses in the stock market, and the bond market as a result. So, what can be done? Well, again, there is no panacea, but one of the things we should be thinking about is better regulation of the gatekeepers I referred to earlier. When we talk about the banks and the mortgage lenders, one item on the agenda is to think about requiring some or all of these firms to keep their loans on their books, or at least some of their loans

on the books, for a longer period of time. Don't allow banks and mortgage lenders to sell their loans quickly because in that case, they're no longer concerned about the creditworthiness of the borrower. We might also worry about the insurers and think about increasing the reserves that they have to keep on hand in order to make good on their promises to pay.

Let's concern ourselves with the rating agencies. We want rating agencies to be more independent. We should reevaluate the system where the rating agencies are paid by the very people whose securities they're rating. One possibility that has been discussed is creating a large pool where anybody who wants to employ a rating agency has to pay into that pool and the rating agency is paid out of the pool. This would address the situation where the banks are paying directly for a particular rating.

And we must guard against systemic failures. We have to be more concerned about assessing risks and what the next crisis is going to be. People often say we shouldn't regulate the last crisis. We shouldn't be concerned about what happened before. We need to look around the corner and try to determine where the next crisis lurks. Why don't I stop there, and respond to questions – [Applause]

PETER WALLISON: Let me make a few points, based on the very lucid explanation that you just heard. Arthur gave a wonderful explanation of a lot of what is going on in the financial markets today. I'm sorry that I did not make clear in my initial presentation that Fannie Mae and Freddie Mac, as government-sponsored enterprises, have been deemed by the capital markets to be backed by the federal government. This backing was not explicit, but investors and creditors believed that the federal government would bail them out if Fannie and Freddie had any financial difficulty, and as a result people didn't pay very much attention to anything that they were doing. They could raise as much money as they needed for whatever they wanted to do. That meant that an awful lot of money was raised and poured into the housing market. It was Fannie and Freddie's investments in the housing market that made the price of housing rise, not only the increase in home ownership that I spoke about, but the fact that there was so much investment going into the housing world via Fannie and

Freddie that caused housing prices to rise. And the fact that housing prices rose made it very easy for the gatekeepers that Arthur was talking about to avoid some of the problems that they were creating, because most of them thought, well, housing prices would continue to rise. This is true also of the rating agencies, and as long as housing prices rose, there was not much concern about whether mortgages might default. It was always possible to sell or refinance the house for more than the amount of the mortgage. That produced a lot of the laxity in underwriting that Arthur pointed to, which certainly was a characteristic of that period.

But the real question is the one that I raised at the very outset: It is not so much the fact that we had inflated prices in housing, but that we had so many bad mortgages. Why are 40 percent of all the mortgages that are currently outstanding in the United States subprime or Alt-A-- that is, junk mortgages? That's the key question, and to my mind, it was the fact that Fannie and Freddie were required to make mortgages that they would not ordinarily make, and it was the fact that the Community Reinvestment Act required banks to make mortgages that they wouldn't ordinarily make that was the underlying cause of the large number of bad loans in the housing bubble. If these institutions would make these mortgages without a legal requirement, then you wouldn't need these requirements. But the fact that these loans were being made because of a government mandate distorted the housing market. And when you have $1 trillion of financing for junk mortgages added to the market just between 2005 and 2007, that can account for an awful lot of the financial crisis we are experiencing today.

In addition, Fannie and Freddie were always regarded as setting the standards for the market. They were the ones who set the requirements for what a conventional mortgage would look like, and it usually had a 20 percent down payment, and a fixed interest rate over a period of time, maybe 20 or 30 years. This was a very solid mortgage. When Fannie and Freddie changed their standards, and started to buy the mortgages that were not very high quality, and not very sound, everyone else in effect had a license to do so. Finally, the chairmen of Fannie and Freddie went to various meetings of mortgage originators-

-the mortgage brokers and mortgage bankers-- and they said essentially, "Look, send us these mortgages. We want to buy mortgages that we haven't bought in the past that are from people who have been underserved, and who ordinarily would not qualify for the kinds of loans we made in the past." In our entrepreneurial economy, when someone who has $1 trillion to spend comes to your meeting and tells you that they'll spend it on whatever you can produce, an awful lot of that stuff is created. And that's exactly what happened.

Now, I want to just say one more thing, and that is about the financial crisis. It is true that there were booms in housing all over the rest of the developed world, including in Europe. And their bubbles have also burst, but the problem for all of these institutions is not their mortgages, because in every other developed country there is no such thing as a non-recourse mortgage. If you were unable to meet your mortgage obligations, you can't walk away from your house. You are still liable on that loan. So, in Spain, England, Germany and France, and in the other places, when there was a mortgage default, it was still possible for the banks to collect from the borrower. Banks in these places would have done well if they had invested only in mortgages in their own country. But many of them invested in mortgages in the United States by purchasing the mortgage-backed securities that Arthur was talking about. Many of these mortgages were part of the $4 trillion in subprime and Alt-A mortgages that I mentioned earlier. Now, how did this create the financial crisis? The answer is that the rapid decline in the value of the subprime and Alt-A mortgages in the United States destroyed the confidence of investors, creditors, and counterparties in the solvency and stability of banks and other financial institutions all over the world. When there is doubt about the solvency of banks, two things happen: First, people will not invest in their stock or make loans to them for fear that the bank will fail. In addition, the banks themselves won't lend, because they are afraid that people will come to them for cash and they won't have it. So, if you're thinking about this from the standpoint of the bank, the bank doesn't want to make any loans until it is very sure that people are not going to have doubts about the quality of its assets and come to withdraw their deposits. And you're not going to make loans even to other banks if you're

afraid that their assets are the same as yours, and declining in value. That is what caused this tremendous financial crisis that we are in today, and that will continue, I believe, until we've set a floor under housing prices, and somehow wipe out or refinance most of the very bad mortgages that are distributed throughout the world.

Now, how do we do that? The original proposal by Hank Paulson and Ben Bernanke, the Chairman of the Federal Reserve, was to establish a Troubled Assets Relief Program, called "TARP." The idea was to buy the bad assets off the balance sheets of the financial institutions – the banks primarily – and put them onto the balance sheet of the US government. What was the advantage of that? First of all, when you buy them off the balance sheet of the banks, you replace them with cash. Cash is wonderful in the sense that it's real capital. It goes right to the bottom line. If you replace depreciating assets with cash, the cash creates solid capital for the institution. The second thing is this: if these assets are going to continue to decline in value, it is better for them to decline in value on the balance sheet of the government. That will preserve the health of the banks. The government can more easily take those losses than the banks can, and not only that: the government can hold these losing assets until, perhaps, everything stabilizes in the housing market, and prices begin to rise again. Then, the government can sell them and perhaps recoup what it spent in buying them.

That is the reason why the TARP was originally proposed. I cannot tell you why it was not actually carried out. There have been stories about why it might not have been carried out – too difficult to assess the value of the assets on the banks' balance sheets was one suggestion – but instead the Treasury Department and the Federal Reserve switched the direction of the TARP and started to make capital investments in the equity of the banks, in most cases making preferred stock investments. They have put almost $350 billion into this effort, but from what I've told you it will not do any good, because as long as the assets continue to decline in value, they just eat through the new capital. The banks don't feel any more confident in their own capital, so that they will start making loans. Thus, it is no great mystery why, despite the fact that

they have gotten over $300 billion in new capital, the banks are still not lending. They won't lend because, if they lend the money, and depositors want their money back, they might be forced into default. So, the only way we're going to solve this problem over the long term is to stabilize the housing prices, but if we want a short-term solution, we have to buy those bad assets off the balance sheets of the banks.

ARTHUR LABY: Let me make a couple of quick remarks regarding Peter's primary point about why the bad loans were made in the first place. You were talking about Fannie and Freddie. You mentioned the Community Reinvestment Act, which I didn't have a chance to address.

First with respect to Fannie and Freddie, I have no doubt that Fannie and Freddie may have played some role, but according to the statistics I've seen they financed about 40 percent of these mortgages. Peter says it was a little bit higher; I've seen 40 percent; some say it was 55. The important point is that many of the subprime loans were, in fact, securitized in private deals with private investors where there was no government guarantee. There was no involvement by Fannie and Freddie. It was simply a case where large institutions agreed to assemble the securitization and sell it off to investors. The process worked in the way I described where there was no involvement of the US government – of Fannie or Freddie.

Second, let's talk about the Community Reinvestment Act, because this is an important point. Many people argue that one of the causes of the crisis was the CRA. This really is an empirical question. We can go back and analyze which loans, or at least we can try to analyze which loans, were CRA loans and which were not. The Federal Reserve wanted to do that. It wanted to try to assess what percentage of the poor-performing loans, if any, was due to the CRA. The Fed conducted this investigation. It analyzed the relationship between the Community Reinvestment Act and the subprime crisis, and it came to three or four conclusions, which are now published.

One conclusion was that the CRA loans that Peter had mentioned were a small portion of the subprime market,

suggesting that the CRA is not really the cause or a primary cause of the subprime problem. The second conclusion was with respect to performance. The Fed went back and determined that loans that were made under the auspices of the Community Reinvestment Act performed at least comparably to other subprime loans. There was symmetry there. As a result, it's hard to say that the CRA was a cause of the crisis when the performance of those loans was similar to loans that were not CRA loans. One interesting bit of data is that the Fed compared the general subprime loans with mortgages that were originated under a program called "NeighborWorks," which partners with CRA lenders. I believe the Fed concluded that these NeighborWorks loans had lower default rates than other subprime loans. Therefore, the CRA in some ways may have helped the subprime crisis because CRA-related default rates were a bit lower than other subprime loans, and lower than conventional mortgages overall. Finally, the study found that there were, in fact, more foreclosures – although this might sound surprising – in middle- and high-income areas. The foreclosure rates were higher in middle- and high-income areas, as opposed to areas where CRA was often employed. If these findings are correct, and the Fed took some time to do this investigation, then we need to give additional thought to whether or not the CRA is really a cause of the crisis.

One final point with respect to the international dimension of the problem: if I understand Peter, he's suggesting that a lot of the loans that were made in the US were then purchased oversees. That may be true, but again, it's an empirical question. We need to retrieve and understand the data with respect to what proportion of loans that were bought by European countries came from the US. More importantly, we should ask what portion of those loans were loans that were underwritten by Fannie and Freddie. It's only after we have that data that we can get a better understanding of the causes of the crisis with respect to overseas developments. Why don't I stop there. You're welcome to make a final remark, or we can take questions.

PETER WALLISON: Let me make just a couple of points about CRA. CRA was, indeed very small. About 3 percent of all loans – subprime or otherwise – were made by banks under

CRA requirements. The importance of CRA is that it began the process of degrading the mortgage system in the United States. It moved mortgage finance away from the stable mortgages that banks had made before. Again, I'm not saying that fewer people should have access to mortgage finance. We should make home ownership available to people who otherwise couldn't buy homes. We just shouldn't do it by distorting the system. In addition, who was enforcing the observance of the CRA standards? The bank regulators. The bank regulators would look at whether banks had, in fact, made the loans that they were required to make under CRA. In other words, they approved loans that they would ordinarily have said banks should not be making, and this made it exceedingly hard for them then to complain about the banks making loans outside CRA that were also below standards. This resulted in the growth of a vast number of subprime and Alt-A loans. And then, finally, I want to say that if you imagine how the system works down at the lowest level, lenders will not spend their time trying to find subprime and Alt-A loans unless they know that there is a market for them—someone to buy them. And for many, many years, subprime lending was a very small business. From 1995 to 2004, the loans that were made by the so-called subprime lenders like Countrywide, amounted to 5 percent of all loans made in the United States. The reason is that these risky loans have to be priced properly, taking account of the higher level of losses they will entail. If you do this, it's a perfectly good business. What changed it was Fannie and Freddie came in with $1 trillion to spend on subprime and Alt-A loans, and that meant we were going to make vast numbers of these loans, which is what happened.

ARTHUR LABY: One final point here. [Laughter] While Peter talked about the CRA degrading the standards, and Fannie and Freddie setting the standards, we have to be careful about taking that argument too far. That may have been what happened in some cases, but going back to the presentation I gave earlier, this is exactly where Peter and I may disagree. Sure the standards may have been different for Fannie and Freddie, or under the CRA, but it's precisely the responsibility of the private actors, the gatekeepers I mentioned earlier, to say, "Wait a second, hold on. What standards are appropriate for us to be using? We're not just going to look at the CRA, or look at Fannie

and Freddie, and copy and paste their standards into our computers." They should know what's right and what's wrong and not cut and paste standards that might be appropriate in the case of CRA loans and use those standards for private sector transactions. It's the responsibility of the private actors to set their own standards, and ensure that the loans are appropriate. Ahmed?

QUESTION: Yes. I had a question. It seems to me when I look at your lecture there are two different things: Number one, I recall both Clinton and Bush boasting about increased home ownership as being an example of our healthy economy. And I also recall that at the end of the Clinton Administration when the dot-com bubble burst, it seems that the only thing at the time that was doing well was the housing industry. It was the only place people could invest. I came to this not knowing much about it. You both did a good job of illustrating it. I have to say that I'm a little bit more persuaded by Professor Arthur Laby. And that's not because he's my professor. [Laughter] It seems to me, as far as the CRA is concerned you've already conceded that it's a good policy to have increased home ownership, but I'm not – and you seem to blame that to some extent by doing these horrible subprime loans, but moving forward, or even retroactively, how can we do the policy-oriented goal of increasing ownership without using these terrible subprime loans? I'm hearing you say that it's the policy and you're criticizing the way Fannie and Freddie did it, but looking forward, how could we have our cake and eat it too?

PETER WALLISON: There should be a government program that subsidizes mortgages, directly with taxpayer funds, rather than requiring the banks or Fannie and Freddie to run such a program--and in that way, as I said, distort the lending process.

QUESTION: The following question is devoted to moving forward: What do you think is the answer? More regulation, less regulation, or (C), different types of regulations, especially when it comes to unfortunately CRA, and what banks are allowed to make?

PETER WALLISON: My prescription is we have to get the

government out of the business of setting the standards for how the housing finance system works, either through government-sponsored enterprises like Fannie Mae and Freddie Mac, or through things like CRA. And if we went back to a system in which we made loans that banks were comfortable with, and weren't required to make, we wouldn't suffer problems of the kind we are encountering today. We would have bubbles in housing, and we have bubbles in other areas, as we did in the dot-com boom period. That's a human nature problem. That's our own exuberance, our sense that things are always continuing to get better when things are going well and prices are rising, and that things are always going to get worse when prices are falling. But the question of what we do about bubbles is another question entirely. We are always going to make things worse for ourselves when we force people to make loans. In this case, they will make low quality loans, so that when the bubble bursts, there's no equity behind them, and all the losses fall on the banking system. When this happens, we get the recession and the financial crisis that we have today.

ARTHUR LABY: Ahmed, just to quickly answer the question you posed: I don't disagree that the government should not be regulating specific standards, but I do think we need much stronger regulation of the gatekeepers that I mentioned earlier. As an example, we should not have a system where the credit rating agencies are not independent. We need to find a way where we can rely on credit rating agencies to give an independent assessment of the situation, and that means finding a way of addressing the conflicts of interest they have today.

QUESTION: Would you agree with that?

PETER WALLISON: No. [Laughter] I'm glad you asked. Two things: First of all, the government is one of the big problems with the rating agencies, too, because the SEC created an approved group of rating agencies. There were three of them, called nationally recognized statistical rating organization, or NRSROs. This seeming approval by the SEC caused many federal and state governments to adopt laws prohibiting pension funds, insurance companies or investment funds from

making investments unless they were rated triple A by one of these nationally recognized statistical rating agencies. In other words, because of the SEC imprimatur, people came to assume that if there was a triple A rating, these were safe. Rating agency approval came to be a substitute for credit or investment analysis by individual buyers. The second thing I'd like to say about Arthur's approach is we have a free rider problem with the rating agencies. His idea was to get some independent people to finance the rating agencies. The trouble is that then everyone who didn't pay for the rating will be able to use it. That's just not going to work, because the people who are paying for the rating agency's rating are soon going to recognize that everyone else is free riding on their payment.

ARTHUR LABY: Well, one idea put forward is if you want a rating, you pay into the pool, so you eliminate the free rider problem by only requiring payment if somebody is actually going to benefit from the system. The point about NRSROs, though, is right. Peter is right that the SEC regulates the nationally recognized statistical rating organizations. Under the Investment Advisers Act, NRSROs can register with the SEC as investment advisers, but that doesn't mean that the problem is regulation. If anything, that means that the SEC didn't do enough to ensure independence. It could have used its authority under the Act to require the NRSROs to be more independent. It didn't go that route, but that's at least one topic that's open to discussion in the future.

QUESTION: [Inaudible]. One of the things that I read in people as diverse as Phil Gross, [Mohamed El-Erian], and George Soros is that this is not a [fed crime]. This is a financial crisis. It's not really specific enough. It's not perspicuous. It's really a credit crisis that when it's precipitated the global synchronized downturn, is in fact, the drawing up of credit [post-Lehman] bankruptcy, and there are two things that [inaudible] mentions as the cause of this, one of which you've mentioned a bit, and that's the credit super-cycle, the keeping rates low for a long period of time. The second is something that neither one of you has mentioned, and it just strikes me as a glaring hole in your attempt to explain the current situation, and that is the role of leverage in the financial system. The failure of the big houses on Wall Street is really the result of leverage gone

wrong in this whole de-leveraging process; what brought the Dow essentially from just above 10 to 7,900 is this post-Lehman de-leveraging. It's a big part of the explanation of the current financial, fiscal credit crisis. Neither one of you has said anything about it, and I don't know how you can purport to explain the current situation without at least acknowledging that this is a big piece of any causal explanation, and then, of course, going forward, what are we going to do about it? Now, that of course, is a wide-ranging policy discussion, but it just seems to me that you have to have some role in your explanation for the role of leverage and the de-leveraging process, and its contribution to the unraveling of the stock market, in the global economy.

PETER WALLISON: You want it?

ARTHUR LABY: You can start the topic. [Laughter]

PETER WALLISON: Well, two things. Leverage was a problem for the Wall Street investment banks, but not for the commercial banks, which are the central problem in the financial crisis. The banks' leverage is controlled by regulators, and what I want to make clear – is that we've put too much faith in regulators; the banks are the most heavily regulated part of our economy and are in the worst shape.

QUESTION: The banks didn't cause the recession in China, if I may. That you have to explain. You can't possibly explain the recession in China to GSEs.

PETER WALLISON: I don't really think I have to explain the recession in China.

QUESTION: But that's implausible. That's totally implausible.

PETER WALLISON: But the banks in the United States are heavily regulated. The banks in Europe are heavily regulated. And the banks are in the most serious trouble right now. So, I think the people who have to explain things are the regulators. They have to explain why it is that they, who have control over the operations of banks, have allowed the banks to get into this kind of position. There were unregulated institutions – the Wall

Street houses you're talking about, the Merrills, and the Morgan Stanleys, and so forth – Bear Stearns, and Lehman – all of them did have very, very high leverage – up to 33 percent. Actually, the European banks that are regulated – UBS, for example – had a 58 to 1 leverage ratio, but the Wall Street houses did become over-leveraged. It is interesting, though, from my point of view that they didn't begin to get that kind of leverage until they were regulated by the SEC, which started in 2004. In 2004, the SEC took over as the safety and soundness regulator of these major Wall Street houses. It had to do that because Europe was insisting that every securities firm or bank that was operating in Europe had to have a national, consolidated safety and soundness regulator. The SEC was authorized by Congress to take on this responsibility, if asked by the securities firms, and several did. It was after that that their leverage ratios went up so high. Before that, they'd operated for 100 years without this problem. So, I understand the point that you are making about the securities firms, but the fact is that the banks, which are in the most trouble, did not have such a high leverage ratio.

QUESTION: But please follow up with this. Isn't that – in talking about regulation, isn't one of the great difficulties this kind of – I wouldn't say [ramification], but these silos of the banks and the investment houses, when in fact, it was the deregulation and the removal of the restrictions on what different kinds of financial institutions were allowed to do that also helped to cause it?

PETER WALLISON: No. It wasn't even close. There's no relationship between the two. What you're talking about is the [Gramm-Leach-Bliley Act] of 1999, which eliminated the affiliation restrictions of the [Glass-Steagall Act]. What that did was repeal the provisions of the Glass-Steagall Act that had prevented banks from affiliating with securities firms. All of the securities firms that got into trouble – all the ones I mentioned – all the big firms, were not in any way affiliated with banks, and none of the banks that have gotten into trouble got into trouble because they were affiliated with securities firms.

QUESTION: But when you talk – I mean –

PETER WALLISON: So, there's nothing about that law which changed the rules in any way that had any affect on the condition of either the banks or the large securities firms.

QUESTION: Well, it goes back to this Fannie and Freddie – it's the same – isn't my argument the same as the argument you're making, which is that it gets them involved – that is their interests now start to mush into different kinds – that is, there's not clear – you can tell by the separation of powers, or checks and balances, but what their – but the way they perceive the world, and the conflicts of what – the policies they're trying to pursue and all, become very different. They've got different affiliates under them. I understand that the affiliate might not be taking them down. In fact, maybe – Bear Stearns had some profitable – or Lehman had profitable sectors that – I mean, affiliates that are still profitable, and they sold those off, but I guess my point is that when you have the super institution that had multiple missions, it becomes harder to kind of pursue prudent policies.

PETER WALLISON: Oh, I agree that it's tougher to manage a diversified institution like a Citibank. But Citibank did not get into trouble because it owned a securities firm. Its securities firm was a rather small firm, the former Smith Barney. In fact, Smith Barney is still a profitable enterprise. They're trying to sell off Smith Barney right now.

QUESTION: No. I [inaudible] understand that.

PETER WALLISON: But Citibank got into trouble being a bank, and doing what banks do. And so we can't really blame what happened to Citibank, or any other bank on the fact that they were allowed to affiliate with securities firms. The securities firms were off in another area, and the large ones never were affiliated with banks, and were doing some other kind of business. There isn't any real connection there. The point I made about Fannie and Freddie was simply that they were so dominant in the mortgage business, they controlled the mortgage business in the United States, and still do, but they set the standards, and if they wouldn't buy bad mortgages, and that was true for many years, there weren't very many bad mortgages being made. When they started to buy them, it

changed the whole nature of the business.

ARTHUR LABY: One comment about the wire houses: I agree that they were over-leveraged. There seems to be no question about that. The question is why that was true. Peter mentioned the shift in 2004. The problem wasn't too much regulation, but it might have been too little. As you may know, the broker-dealer firms are subject to net capital rules that are set in part by the SEC. They're established, to some extent, by the staff in the Division of Trading and Markets and approved by the Commission. They can be revised based on Commission rules. For years, the broker dealer firms were subject to net capital requirements. A change took place in 2004 that was deregulatory; although there's some disagreement about whether the changes were meant to be more regulatory or deregulatory. In 2004, some of the firms became Consolidated Supervised Entities – CSEs – and their capital requirements were eased. Many people are arguing today that had we not allowed the large firms to get away with such lax net capital requirements, we wouldn't have some of the problems that we see today. One of the changes that we're likely to see in the near future is enhanced capital requirements of the large broker-dealers.

PETER WALLISON: Let me just add to that, or say that this is one area that we can actually research, and maybe you can find out the answer for me. The institutions that got into trouble – Lehman, Merrill, Morgan Stanley –

QUESTION: Bear Stearns?

PETER WALLISON: – Bear Stearns and Goldman Sachs – were not the broker dealers. They were the holding companies of the broker dealers. There was in fact a change in net capital requirements, but that applied to the broker dealers, not to the holding companies. The holding companies were what were regulated by the CSE rule, and I don't think that the changes that were made in April of 2004 actually applied to anything but the broker dealers. We see that because Lehman's broker dealer was a profitable enterprise, which was sold off to Barclays Bank after the bankruptcy. So in fact, the broker dealers remained as

fairly stable, solid institutions, obeying solid net capital rules. The holding companies were the ones that went crazy.

ARTHUR LABY: Both banks and investment houses got into trouble because they held mortgage-backed securities. It's true for Wachovia, for Merrill Lynch, for Lehman Brothers. If that's the case, then isn't some of the problem in the way the securities are created and the fact that certain laws did not apply to them? For example, you mentioned insurance, but derivatives used as insurance were not highly regulated. States generally did not regulate the bets on whether these mortgage-backed securities would go up or down. The credit default swap market was largely unregulated.

PETER WALLISON: Yes. That's true. Credit default swaps are not regulated now, and as far as I can see no one has presented an argument why they should be regulated. They are nothing more than a contractual obligation to pick up someone's debt.

ARTHUR LABY: Right.

PETER WALLISON – and as a – why do you make a face? I don't understand why that – [laughter] –

ARTHUR LABY: Because they don't have a capital requirement behind them.

PETER WALLISON: But a person who – excuse me, but the person who buys the protection from someone like AIG is the one who has to worry about whether there's adequate capital, not the rest of us. If AIG does not have adequate capital, then the protection that you bought is not useful. In addition, the problem with AIG was that it was triple A at the time it sold all these swaps, and when it was downgraded, it then had to start putting up the collateral that is required by the swap contracts, and it didn't have the collateral. That's why it got into trouble, and that's why the government thought it had to take AIG over. But the credit default swaps were not the problem. Swaps just move an obligation from one place to another; AIG got into trouble because it did not properly evaluate the risks it was taking on.

ARTHUR LABY: But wait, we do need to worry about the safety and soundness of large institutions, and I tried to demonstrate, at least through one example, why we needed to worry about the safety and soundness of Lehman. Consider the implications for the rest of the economy when an entity like Lehman Brothers fails overnight. We didn't talk about credit default swaps, but if the advent of credit default swaps can cause a company like a Lehman Brothers to fail over the course of several days or several weeks, then we need more transparency and regulation of instruments like credit default swaps to avoid precisely the rippling effect that I mentioned earlier.

PETER WALLISON: I want to take that point on, also. [Laughter] Because, in fact, we have had failures of large important institutions that have not caused a rippling effect. I'm thinking of Drexel Burnham, which failed in 1990, a big securities firm, as big at that time as Lehman was in this time. The reason that there were no problems when Drexel failed is that there was no concern by investors all over the world about the health and stability and solvency of all other financial institutions. The reason Lehman's failure caused all this trouble was that investors were very nervous at the time, as they were at the time when Bear Stearns was rescued. The reason Bear Stearns was rescued was that regulators thought if we don't rescue Bear Stearns there will be a panic by investors all over the world, because they're all worried about the financial health of banks and other financial intermediaries. Letting Lehman fail turned out to be a mistake, because I don't think that Bernanke and Paulson actually understood how nervous investors were at that moment. The huge panic resulted not because Lehman's failure would cause others to fail, but because it made investors, counterparties and other banks realize that they and all the major financial institutions were in trouble and might not be rescued. In fact, when Lehman's credit default swaps were finally resolved, the losses were very small. You can't point to any institution anywhere in the world that actually lost so much as to jeopardize its financial health as a result of Lehman, and yet Lehman was a very big institution. So, the reason that everyone got scared was because what Lehman's failure signaled was that the governments were not going to protect all of these other players, and if the governments were not going to protect

them, then making loans to them in the future was going to be a very much more risky business.

ARTHUR LABY: That might also demonstrate the difference in the economy between today and twenty years ago, when Drexel Burnham failed. The interconnectedness of today isn't necessarily the same as the relatively simpler economy of the 1980s.

PETER WALLISON: I think the financial world is always interconnected--that's why financial institutions are called "intermediaries." They're all intermediaries in the process of moving money from one area, where it is not useful, and getting into areas where it is more useful, or most useful, and that process has made the financial institutions interconnected for 200 years. This is nothing new.

MODERATOR: What do you see as the implications of the solutions that are currently on the table of renegotiating mortgages, and also of the injection of funds through infrastructure, and all these other projects, which seem to be on the table?

PETER WALLISON: I think it's going to be essential for the government to renegotiate and refinance mortgages, and it has to be done in two ways – two important ways. First of all, it can't be done retail; it can't be done mortgage by mortgage. As we've said, there are 25 million Alt-A and subprime mortgages out there. You can't do that within our lifetimes. It has to be done on some sort of wholesale basis. The second thing is the principal amount of the mortgages must be reduced. Simply reducing the interest rate will not be enough to keep people in their homes. The banks are going to suffer losses on these mortgages, because people are not going to pay them, and the banks are going to have to foreclose, which is an expensive process; then they're going to have to sell the homes, which will be a loss. So, from the bank's point of view, they should be very eager to sell their mortgages to someone – I recommend it be Fannie Mae and Freddie Mac at a loss – a 20 percent loss, a 30 percent loss, whatever they assess. The government should say to them, "We will buy all of the mortgages you want to sell us for a 20 percent discount from the principal amount of

those mortgages." The government then passes that discount on to the homeowners. Most people will take that, I think, but there has to be something added that provides assurance of some kind that people are not just taking it for the sake of getting some sort of assistance-- that they actually are interested in keeping their homes. So I would make those mortgages recourse mortgages, not non-recourse mortgages. So, a person who signs up for such a mortgage realizes that he or she is saying, "I'm going to work to keep this home. I'm going to work to pay off this mortgage, because I understand that if I don't, the government might come after me on the note." That's my plan.

MODERATOR: Just if I could – just time for maybe one or two more questions.

PETER WALLISON: Another student of yours?

ARTHUR LABY: Yes. I think this is.

PETER WALLISON: What did you do here? [Laughter]

ARTHUR LABY: I paid them. [Laughter]

QUESTION: I actually had a question for Peter – I'd say, Mr. Wallison, you talked earlier about government-subsidized mortgages. I wasn't sure if that's what you were – just trends right now, or whether you envisioned something similar – whether the federal government or a state government offered to make both, and whether it's going to be something similar to our student loans, we'll get direct loans from the government? If that's a possible solution, as well? And Professor Laby, I have a question for you in regards to the primary reserve fund you talked about, and the common paper – the commercial papers, whether there are any costs that the government or maybe use their [TARP] funds to sort of maybe provide as a government primary reserve fund right now, just to get things going again?

ARTHUR LABY: I'm sorry. I didn't hear the question Kenji.

QUESTION: Whether government is actually – if there are any costs – whether the government would use maybe the TARP funds – the government funds – to provide sort of –

PETER WALLISON: Commercial paper.

ARTHUR LABY: I understand.

QUESTION: The money you can get? And a follow-up question to that would be whether – are there any other industries where they have gatekeepers that you're suggesting, where they are truly independent, and whether that's worked or not, and whether that can be seen to transfer to this financial crisis, as well?

PETER WALLISON: I got it.

ARTHUR LABY: Why don't you start with that.

PETER WALLISON: Yes. If you're referring to my suggestion for a government policy for promoting homeownership, I would have a very simple policy in that case. The government would lend people the down payment on a home on a subordinated basis. Studies show that the real problem for people in buying homes is not the interest rate, which is where Fannie and Freddie and CRA came in. It is the down payment problem, and so what I would suggest is that the taxpayers support a government program of some kind, a down payment assistance program in which people would get a down payment from the government, and they could then use that down payment to buy a home. Eventually they would have an obligation to repay the government.

QUESTION: Sir? A follow-up, quickly. I think the University of Pennsylvania had this one program where they actually subsidized their employees to revitalize West Philadelphia by giving them, I think, [partially for down payment]. Is that something similar?

PETER WALLISON: I don't know that plan, but it sounds like it's quite similar to it. But that's an honest way in my view to get home ownership increased. As a society, we want this to

happen. We want more people to own homes, so who should bear the cost? The shareholders of the banks, or the shareholders of Fannie Mae? No. We ought to have the taxpayers pay for something that would benefit our society as whole.

QUESTION: Would you see that as more of a federal role, or is it more on the state level?

PETER WALLISON: Well, the states can do it, too, but obviously the federal government has the resources that the states don't have.

ARTHUR LABY: Kenji, to answer your questions: With respect to the government having a role in money market funds, the government had to step in after the Reserve Primary Fund debacle and shore up money market funds, and give the confidence to the investing public that money market funds would not fail, so the short answer is yes. There were talks immediately afoot with respect to how to do that, and the government had to jump in and play a role with respect to money market funds. You're right about that.

QUESTION: So, does that mean the government regulates it?

ARTHUR LABY: Well, no, not exactly, but immediately after that crisis the government had to step in, in the short-term, and make it clear that they would not allow money market funds to fail like the Primary Reserve Fund. You also asked about gatekeepers and other examples where gatekeepers play a role, the short answer is yes, they play a role in other transactions. One that you might be familiar with is a typical underwriting – a stock underwriting – when a company decides to issue securities. In that case, the company hires an investment bank to help them do that. There are a number of gatekeepers involved in the process. The investment bank itself acts as a gatekeeper with respect to that underwriting to ensure that the stock is priced appropriately, that there's going to be a market, and that the company is making all of the disclosures it's supposed to be making. The company must hire auditors and accountants to look at the books. Those auditors and accountants are gatekeepers to ensure that the public is getting

complete disclosure of the financial information about the company. Lawyers who work for both the investment bank and the issuer are also gatekeepers. The lawyers are looking over the documents to make sure that they're correct; they're going to question any time there's a possible misstatement or omission in the document. The lawyers are gatekeepers as well.

We've seen in recent years more regulation of the gatekeepers. One example you might find of interest is the regulation of lawyers. When Sarbanes-Oxley was passed, Congress required the SEC to write rules to make sure that if lawyers are appearing and practicing before the SEC (which is broadly defined), if those lawyers see any material violations of law in the course of their work, they must wave a red flag. They must report that violation within the issuer, within the company, at higher and higher levels until eventually that report, in some cases, would go to the board of directors. So, yes, we place significant responsibility on gatekeepers, and we've done, I think, some useful things in recent years to ensure that they're doing their job.

QUESTION: Inside [inaudible], is there a general acceptance of what the price is, to know what the value is? For example, you were talking about if the government provides a down payment, what's the ratio that they should have it?

PETER WALLISON: Traditionally, it was 20 percent – 20 percent down payment. Eighty percent loan to value was the traditional mortgage.

QUESTION: You always had problems, like the DA, right? Which –

PETER WALLISON: Well, right.

QUESTION: Right, right, which did what you were advocating?

PETER WALLISON: That's right.

MODERATOR: Thank you. [Applause]

[END OF SYMPOSIUM]