Newsweek

What Should Uncle Sam Do?

NEWSWEEK's Business Roundtable takes stock of the real damage—and offer solutions to the economic crisis.

NEWSWEEK
Updated: 1:50 PM ET Jul 19, 2008

A Modest Proposal

Robert Reich *, secretary of Labor under Bill Clinton, and author of "Supercapitalism: The Transformation of Business, Democracy, and Everyday Life"*

Of course Fannie and Freddie are getting bailed out. They're Bear Stearns to the 10th degree—way too big to fail, especially with the rest of the Street in turmoil. And of course taxpayers get stuck with the tab.

What worries me is the complete lack of accountability by Fannie's and Freddie's executives, as well as Wall Street investment bankers also now being insured by taxpayers. We've created the worst form of socialized capitalism—private gains combined with public losses. These executives and bankers are among the best paid in all of corporate America. Their organizations are treated as if they're giant investor-driven private sector entities as long as they're healthy. But when they start to go down the tubes they become public entities with public responsibilities, and the rest of us have to bail them out.

Surely there will be more failures or near failures of financial institutions in the coming months, and American taxpayers will once again be called on to insure their solvency. The important question is what conditions should be applied.

Herewith a modest proposal: when taxpayers insure a giant entity against loss—Freddie, Fannie, Wall Street investment banks, whatever—the entities must agree that (1) for the duration of the bailout, their top executives cannot receive total annual compensation higher than that received by the president of the United States, and (2) the government gets 5 percent of their current valuation as shares of stock (roughly representing the benefit to their shareholders of the federal insurance). If and when the entities become profitable again, taxpayers are thereby compensated for the risk they've taken on.

The Dangers of Getting Too Cozy

Larry Lindsey, *former governor of the Federal Reserve and former economic adviser to President George W. Bush*

The recent troubles at Fannie Mae, Freddie Mac and IndyMac show just how messy things can get when the relationship between the government and the market gets too cozy. Fannie and Freddie are private for-profit concerns that operate for the benefit of the shareholders, but with government intervention both in their mission and as a source of bailout money when things go badly. This leads to both the privatization of profits with the socialization of losses and political interference in the processes of profit making and loss mitigation.

The plan advanced by Secretary [Henry] Paulson provides an open-ended source of funding for the government to buy the stock of the companies and to lend them unlimited amounts of money. While it may be a necessary last-ditch effort to save them, the plan leaves existing management and directors in place and asks for no explicit accountability for existing shareholders and other investors. Unfortunately, this appears to be related to the enormous political power Fannie and Freddie have developed through decades of political contributions and management by politically connected individuals like Frank Raines [Clinton's

OMB director and former chief of Fannie Mae] and Jim Johnson [until recently an Obama adviser. Johnson was also chairman of the Goldman Sachs board's compensation committee while Paulson was its CEO].

The immediate cause of the failure of IndyMac was, according to its regulator, the release of a letter questioning the solvency of the institution by Sen. Chuck Schumer of New York. This also highlights the problems of politics and the market getting too close. While the senator was clearly within his rights to write the letter to the regulator, releasing it to the public undermined the regulator's ability to fix the institution without causing a bank run or the loss of taxpayer money. Moreover, now that pictures of people lining up outside the bank trying to get their money have been broadcast, other financial institutions may also find themselves in trouble.

These close interactions between politicians and regulated businesses sap public confidence in both government and the market. Real GSE [government-sponsored enterprise] reform and more caution on the part of politicians before interfering publicly in the business of regulators would help address these worries.

The Lessons of the Great Depression

Jeremy J. Siegel *, professor at Wharton Business School*

Given the turmoil in U.S. capital markets, our government had no choice but to rescue Fannie Mae and Freddie Mac. These mortgage giants, which had long been undercapitalized, had become far too important to the faltering housing market to see them go under.

Now that the government has stepped in, it is mandatory that Congress structure its investment so as to capture any gain in their stock price, similar to the profit that the government realized when it bailed out Chrysler Corp. in 1980. There is no reason that this deal should only become a "heads, the stockholders win" and "tails, the taxpayers lose" proposition.

Although the use of taxpayer money is regrettable, the novel and aggressive policies that the Federal Reserve has pursued during these fragile economic times have been necessary to maintain financial stability. Certainly [Ben] Bernanke didn't foresee the extent of the credit crisis, but he has acted forcefully since last August to open the discount window to troubled institutions, expand domestic and international lending facilities, and rescue Bear Stearns. These policies have quieted the financial markets and have brought both a significant reduction in short-term rates for borrowers and a reduction in default spreads.

Government bailouts are not without their downside. Promises of bailouts may encourage firms to take excessive risks (what economists call "moral hazard") if they know the government will come to the rescue. That is why the Fed must enact stringent capital requirements, as they do for banks, for any firm for which it provides a safety net.

But moral hazard should not stand in the way of aggressive policy. When the government established deposit insurance in the 1930s, many worried that such legislation would lead to excessive risk-taking by banks. Yet many economists now name deposit insurance as one of the most important economic reforms of the past century.

What the Fed learned from its failure to bail out banks during the Great Depression has kept the financial system intact and the economy functioning during this historic meltdown in the real-estate market. Had the Fed not intervened forcefully, it is quite likely that we would have seen a downward spiral of market prices and economic activity that could have rivaled the 1930s.

No One Is 'Too Big to Fail'

John Snow *, former Treasury secretary under George W. Bush, now chairman of Cerberus Capital Management*

The current turmoil results from excessive risk-taking and imprudent lending based on the assumption that housing prices would rise indefinitely. We now have a long-overdue correction. Government's proper role is to provide for an orderly adjustment while allowing the underlying market forces to work. Although it is

painful and disruptive, the sooner it is resolved, the less injurious the spillover to the rest of the economy will be.

Society benefits when financial institutions take prudent risks. But when they are imprudent, for markets to work institutions must be allowed to fail. We allow banks to fail—witness IndyMac—but there is an orderly system overseen by a strong regulator.

In today's global economy, no one is too big to fail. Financial institutions engaged in similar activities should be governed by similar capital requirements, lending standards and the discipline of the marketplace, regardless of size.

Fannie and Freddie operated like hedge funds, arbitraging their implied governmental status, motivated by profits for shareholders. This leverage created systemic risks so large that the enterprises are now on the taxpayers' doorstep.

Given the risks of contagion, there was arguably a case for a short-term Band-Aid. In some sense it was preordained. But it should be allowed only if action is also taken at the same time to prevent this situation from ever happening again.

The current result was predicted three years ago, when we asked Congress to create a strong regulator over the enterprises' capital and activities, with power for an orderly resolution if they got into trouble and failed. The situation today would be much more manageable if action had occurred then. This is now the opportunity to finally get it done.

The price of short-term government support must be a long-term solution designed to protect taxpayers. Otherwise, we face the worst of both worlds—paying once now, and paying again as we continue to subsidize a larger and even more catastrophic financial market failure sometime in the future.

The Argument Against the Status Quo

Robert Rubin *, Treasury secretary under President Clinton, now chairman of the Citi executive committee of the board*

Since roughly a year ago, our credit markets have been experiencing what has increasingly become something of a perfect storm, as a consequence of a confluence of forces: underweighting of risk across asset classes, including credit extension; massive use of financial engineering, including with respect to subprime mortgages; low interest rates that led to a reaching for yield; rising housing prices that created complacency among borrowers and lenders as mortgage finance was used to fund consumption during a period of stagnant median real wages, and AAA ratings for certain investment instruments based on subprime mortgages. At the same time, consumption has run into increasingly powerful headwinds from the worst declines in housing prices since the 1930s, an explosive increase in oil prices, increasing mortgage defaults and other factors. All this adversely affects the economy, which could then possibly feed back into credit markets, consumption and investment.

While our economy has substantial underlying strengths—its flexibility and dynamism, healthy corporate balance sheets and strong exports—the risk of today's serious difficulty continuing for an extended time, and perhaps worsening, is sufficient to continue calling for a highly proactive policy response. The fiscal-stimulus and GSE legislation earlier this year, the various actions of the Federal Reserve Board and the intervention of the Federal Reserve Board and Treasury to prevent the failure of Bear Stearns were all constructive. The actions on Bear Stearns were necessary because it was extensively interconnected with the rest of the global financial system, so that its failure could have led to serious crisis. Fannie Mae and Freddie Mac are even more deeply interconnected to the rest of the financial system, through the massive holdings of mortgage securities they've guaranteed, through their debt, and through the critical role Fannie and Freddie play in the ongoing economy. Thus, Treasury should be given the capacity to act if it concludes that is necessary. Moreover, the authority should be open-ended—both to provide the confidence to the markets that would reduce the probability of that authority being needed and to make that authority effective if it is needed.

In addition, pending legislation to facilitate mortgage renegotiation should be enacted. Foreclosure proceedings involve enormous economic inefficiency, and facilitating renegotiations would increase economic efficiency, reduce risk to our economy and help many struggling families.

The Bear Stearns and Fannie Mae-Freddie Mac situations manifest a larger reality: in today's global system, every major financial company has vast contractual obligations to other companies throughout the world. This is largely as a result of the exponential increase in financial engineering that has created contractual commitments in the form of derivatives and other similar instruments. If any of these systemically critical institutions were to go into default, the consequences for the rest of the system could be severe or worse. For the immediate future, that means policymakers must act to prevent such default where the threat to the system is great enough, while at the same time minimizing the moral-hazard consequences. And, for the longer term, this new reality means that our financial system should be reformed: to provide comprehensive and greatly increased margin and capital requirements for those products of financial engineering; to extend the bank regulatory regime to other systemically significant institutions; to provide sensible guidelines with respect to off-balance-sheet financing, and quite possibly to move from the mark-to-market accounting that has contributed so greatly to market disorder in the current situation to an accounting methodology more like the reserve accounting used for bank loans.

Our market-based financial system has contributed greatly to our economy, and is far preferable to a government-directed system. However, we must address immediate threats to our economy, and we must act on the lessons of the current crisis to reduce systemic risk in the future. The objective is not to eliminate or even minimize risk, but rather to optimize the balance between increasing protection and preserving the benefits of our free-market system. Moreover, all these changes, both in the short term and the long term, are technically very complicated and involve difficult trade-offs. But not acting is also a decision, and we would be far better off by moving forward than maintaining the status quo.

Failing to Learn the Lessons

Peter Wallison *, general counsel for the Treasury and the White House in the Reagan administration, now Arthur F. Burns fellow in financial policy at the American Enterprise Institute*

Assuming that congress adopts the Paulson plan, the Fannie MAE and Freddie Mac crisis is likely to fade away. The secretary's package assured the markets that the U.S. government stands behind Fannie and Freddie, and hence assures a continuing flow of the funds they need to operate. This will enable them to survive until and unless their regulator declares that they are insolvent, and this is unlikely to happen if housing prices stabilize over the next three or four months. Of course, if housing prices continue to deteriorate, Fannie and Freddie will both be in jeopardy of insolvency, in which case the government will have to step in and take control of them. But this I assess as unlikely.

With Fannie and Freddie successfully, if temporarily, tucked away, the greatest danger we face is failing to learn the lesson they teach—that government backing for a private, shareholder-owned company will inevitably come to a bad end. Government backing creates moral hazard, inducing lenders to shed the wariness they usually display in lending to an ordinary company; the easier money thus obtained, and the lack of market discipline, permits managements to take extraordinary risks in pursuit of extraordinary profits. As with Fannie and Freddie and the S&Ls before them, these risks turn into losses that the taxpayers must absorb.

That Washington has not learned this simple lesson is shown by the proposal—supported by both Fed chairman Bernanke and Treasury Secretary Paulson—to put investment banks under the supervisory wing of the Fed. There you go again, as Ronald Reagan would say. This will remake the swashbuckling investment banks—inveterate and successful risk-takers—into incipient Fannies and Freddies, gambling with taxpayer money and growing flush with the lack of market discipline.

Not to worry, we will be told. The Fed will be on watch. Is this not the same Fed that—together with its brother bank regulators—allowed the heavily regulated banks to fail in underwriting subprime loans and set up off-balance-sheet investment vehicles? Washington is a strange place; every time regulation fails, Congress gives us more of it.