

Progressive conditions for a bailout¹

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The events of the last month showed the urgency of dealing with the financial crisis. There is a real risk that the banking system will freeze up, preventing ordinary business transactions, like meeting payrolls. This would quickly lead to an economic disaster with mass layoffs and plunging output.

The Fed and Treasury are right to take steps to avert this disaster. While there is an urgency to put a bailout program in place, there are several important issues that Congress should address in the context of bailout.

While there is not time to prepare all the details of the financial restructuring that will follow after the bailout, there can be an agreement on the outlines that this restructuring should take. This list of suggestions is presented in that context:

Principles to guide the bailout

1. Financial institutions should be forced to endure the bulk of the losses with taxpayer funds only used where absolutely necessary to sustain the orderly operation of the financial system.
2. The bailout must be designed to minimize the opportunity for gaming.
3. The bailout should be designed to minimize moral hazard.
4. In the case of delinquent mortgages that come into the government's possession, there should be an effort to work out an arrangement that allows the homeowner to remain in her house as owner. If this proves impossible, then former homeowners should be allowed to remain in their homes as renters paying the market rent. This should be done even if it leads to losses to the government.
5. There should be serious efforts to severely restrict executive compensation at any companies that directly benefit from the bailout.

Principles for restructuring the financial system

1. Combating asset bubbles must be one of the Fed's key responsibilities.
2. The government should impose a modest financial transactions tax, comparable to the one in the United Kingdom. This can both restrain excessive trading and raise more than \$100 billion a year in revenue.
3. Regulatory agencies should require that potentially tradable assets (e.g. credit default swaps) actually be traded on exchanges.

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4. There should be strict limits on leverage for all regulated financial institutions.
5. Fannie and Freddie should remain fully public institutions, returning them to a status comparable to Fannie's prior to its privatization in 1968.
6. The Fed should be restructured so that all the key decision makers (e.g. the open market committee) are appointed by democratically elected officials. Its responsibility is to manage the economy in the interest of the general public, not the financial sector.

Given the urgency for passing a bill, Congress should look to enshrine principles in a bailout bill that will allow subsequent legislation to circumvent ordinary procedural issues (e.g. the filibuster in the Senate).

Principles to guide the bailout

1. Every effort should be made to ensure that the financial institutions bear absolutely as much of the cost of these bailouts as possible, thereby minimizing the cost to the taxpayer. This is important not just to protect taxpayers. The managers who got their institutions and the country into this housing and financial crisis exercised extremely bad judgment. They should be forced to face the consequences of their actions. Similarly, the shareholders who benefited on the upside of the housing bubble should be forced to experience the downside that resulted from risky investment strategies.

Without details of the plan, it is difficult to say how best to accomplish this task, but one obvious way is to have an equity stake be the price of admission to the auction system. For example, any company could be forced to sell itself to the government in proportion to the assets it puts up at auction. For example, if the government buys \$10 billion of its junk-rated mortgage backed securities, then it gets an equity stake in the company of \$2 billion. This would also get around the issue of having foreign financial institutions get into the mix. If UBS or other foreign banks want to sell themselves to the U.S. government, they can be given that option.

2. A big part of our financial problems stems from the corruption of the appraisal/rating processes. This occurred both at the level of home appraisals in the mortgage industry and at the level of the bond rating agencies who gave investment grade ratings to mortgage backed securities and derivative instruments that did not deserve this status.

This creates an obvious problem for any reverse auction system of the sort being described by the Treasury. One way that a bank can offload much of its assets at these auctions is to misrepresent the quality of the asset. In other words, if there is a reverse auction for near-investment grade MBS, and a bank offers to sell a large amount of complete junk, that it claims to be near investment grade, then it is likely to be a big winner at the auction.

A way to limit such gaming would be to structure the contracts so that both the companies and their managing executives are personally liable for the subsequent

performance of any assets they unload. If the assets perform substantially worse than other assets in the same grade, then they can be sued to make up the difference.

For example, if Citigroup sells \$10 billion worth of assets in a particular investment grade, and the loans in this sale end up having a default rate that is 20 percent higher than other loans in the same investment grade, then the government can sue Citigroup and the executives who signed off on the sale to collect the difference, plus some penalty.

This provision can be written so that normal variance would not trigger any action (e.g. if the default rates are 5 percent higher). This will provide a substantial disincentive for the most obvious form of gaming.

3. The bailouts so far have allowed the institutions that took irresponsible risks to fail (e.g. Bear Stearns and Lehman Brothers), while protecting their creditors. This has the effect of punishing the executives and shareholders of these institutions, but allowing those who foolishly lent money (often for high returns) to escape unscathed.

Any future bailouts should also ensure that those who took excessive risks suffer the consequences, but they should also attempt to ensure that creditors exercise better judgment in their loans in the future. One way to do this would be to initially allow the creditors of failed institutions to recoup their funds immediately, but to reserve the right to reclaim some of this money for loans that carried especially high rates of return.

For example, if a creditor had lent Bear Stearns money at a 15 percent interest rate the month before its collapse, there is no reason that the government should fully honor this debt. The lender obviously understood that this was a high-risk loan at the time it was made. Any loan to a failed institution should be subject to such a review, which could result in a demand for a partial repayment to the government. This would only apply to large loans, since there would be little point in scrutinizing a loan for \$20,000.

4. The government will inevitably come into the possession of a vast amount of mortgages in various stages of delinquency. The priority in these cases should be to allow people to remain in their homes, not maximizing the return on the mortgages.

This should mean first a good faith effort to negotiate a write-down that makes it possible for homeowners to remain in their house as owners. If this proves impossible, then the next recourse should be to give homeowners the option to remain as renters paying the market rent for the house. Only if the homeowner can neither arrange a new mortgage nor pay the market should the government move ahead with foreclosure procedures. This is a subsidy to homeowners, but it is a relatively small subsidy to people who were often the victims not only of abusive marketing practices by the mortgage industry, but an explicit government policy to push moderate income families into homeownership.

It is also important that renters in foreclosed properties have their rights protected. This should mean, at the least, that any existing leases be honored and also that a reasonable time period be given before a new owner is allowed to carry through with the eviction of tenants.

5. The government can set whatever conditions it wants on participating in the reverse auctions. One of the conditions it should set is that executive compensation be severely

constrained at any financial firm that participates. For example, it can set an absolute limit of \$2 million in total compensation for any executive at any firm that takes parts in the reverse auction.

Since participation in the auction is completely voluntary, this would make the cap voluntary. Furthermore, there need be little fear about losing good talent, because well-managed firms would not have to participate in the reverse auction.

Restraining compensation on Wall Street will be incredibly important in reversing the pattern of inequality that has developed over the last three decades. The exorbitant compensation packages on Wall Street distorted pay structures throughout the economy.

Executives at non-financial companies looked at the pay on Wall Street and used this as a basis for demanding outrageous pay packages for themselves as well. Presidents of universities often get over \$1 million a year, and even top executives at private charities can often earn near \$1 million a year. These salaries seem low when compared to their counterparts in the corporate world, but they are outrageous when compared to the pay checks of typical workers. If we can bring about voluntary pay restraint on Wall Street with this bailout, it will be a very big step toward reversing the pattern of inequality that has developed over the last three decades.

Principles for restructuring the financial system

1. The Fed must see the combating of asset bubbles as one of its main responsibilities, along with maintaining high employment and low inflation. We are in this crisis because Alan Greenspan chose to ignore first the growth of a \$10 trillion dollar stock bubble and then an \$8 trillion dollar housing bubble.

The Fed has a wide variety of tools that it can use to rein in bubbles, starting with talk. The Federal Reserve Chair regularly testifies before Congress and frequently speaks in other public forums. The chair can use these occasions to lay out evidence that a bubble exists in a financial asset and to explicitly describe the potential risks to the actors involved.

or example, in 1998 and 1999 Alan Greenspan could have carefully explained that price to earning ratios in the stock market were inconsistent with any plausible projection of corporate profit growth. He could have explained the risks that pension funds and other investors faced from being heavily invested in an over-valued asset.

Similarly, if Greenspan had pointed out in 2002-2006 that house prices had hugely diverged from a 100-year long trend, rising by more than 70 percent in real terms after staying flat for 100 years, then it is likely that many people would have paid attention. He could have also pointed out that many of the holders of mortgage backed securities and derivative instruments were taking very serious risks, since these assets would suffer large losses with a reversal in the housing market.

It is difficult to believe that if Greenspan had made these sorts of explicit warnings, it would not have an impact on the bubbles in the stock and housing markets. Economists and financial analysts can certainly have differing views on the state of the economy, but it would be incredibly irresponsible to simply ignore clearly stated warnings from the Fed.

In addition to the impact of explicit warnings, the Fed also has substantial regulatory authority that it can use to rein in bubbles. The main tool in the case of the stock market is the margin requirement for borrowing to buy stock. Raising the margin requirement by itself would have little impact (relatively little stock is bought with margin borrowing), however raising the margin requirement would be a clear warning that the Fed views the stock market to be over-valued.

The Fed has more extensive regulatory powers with regard to the housing market. Its failure to use these powers allowed for the proliferation of questionable mortgage practices.

The Fed can raise interest rates to rein in financial bubbles. This is an extremely blunt instrument that also has the effect of slowing the economy and throwing people out of work. For this reason, the Fed should be very hesitant to use higher interest rates as a weapon against asset bubbles. However, in the case of the housing bubble, if the Fed's other tools were insufficient for containing the bubble, it would have been appropriate to raise interest rates to prick the bubble, even at the cost of slowing the economy.

2. Congress should impose a modest financial transactions tax with the explicit purpose of reducing excessive trading and downsizing the financial sector. The financial sector has exploded in size over the last three decades. It accounted for more than 30 percent of corporate profits in 2004. Back in the 1950s and 1960s, the country's period of most rapid growth, the financial sector accounted for less than 10 percent of corporate profit.

The financial sector performs an incredibly important function in allocating savings to those who want to invest in businesses, buy homes, or borrow money for other purposes. But shuffling money is not an end in itself. The explosion of the financial sector over the last three decades has led to a proliferation of complex financial instruments, many of which are not even understood by the companies who sell them, as we have painfully discovered.

The best way to bring the sector into line is with a modest financial transactions tax. Such taxes have long existed in other countries. For example, the United Kingdom charges a tax of 0.25 percent on the purchase or sale of share of stock. This is not a big deal to someone who holds their shares for ten years, but it could be a considerable cost for the folks who buy stocks in the morning that they sell in the afternoon.

Scaled taxes on the transfer of other financial instruments (e.g. a 0.02 percent tax on a trade of an options, future, or credit default swaps.) could go a long way in reducing speculation and the volume of trading in financial markets. Such a tax could also raise an enormous amount of money--easily more than \$100 billion a year. This would go a long way toward funding new programs or reducing the budget deficit.

And, this tax would be hugely progressive. Middle-income shareholders might take a small hit; but it would be comparable to raising the capital gains tax rate back to 20 percent, where it was before it was cut to 15 percent in 2003. The real hit would be on the big speculators.

3. Tradable instruments, like credit default swaps, should be standardized and traded on regular exchanges. One of the factors that made the financial system so vulnerable was the proliferation of credit default swaps and other instruments that were not publicly traded. This

makes regulation very difficult, since regulators don't have good current information on the volume of these assets. In addition it leaves companies with a large amount of discretion in their accounting for these assets, since they don't have an exchange determined price.

4. There need to be much tighter restrictions on the extent to which financial institutions can leverage themselves. Profit maximization will encourage firms to become as leveraged as possible. In principle, the market should provide discipline, charging high interest to heavily leveraged firms. However, if lenders either exercise poor judgment or assume a government bailout will protect them (as has been the case in this instance), then the market will not by itself prevent excessive leverage.

Any institution subject to regulation should face tight restrictions on leverage. There should be absolute commitment that lenders to any institution not subject to financial regulation will not be bailed out.

5. Fannie Mae and Freddie Mac should remain as public corporations, operating in a manner similar to the way Fannie Mae operated prior to its privatization in 1968. These institutions play an important role in making low-cost mortgage money available nationwide by sustaining a secondary mortgage market. While they operated poorly in the housing boom, making risky loans and becoming overly leveraged, they still acted more responsibly than private issuers of mortgage backed securities, just about all of whom are now out of business.

There will continue to be a role for Fannie and Freddie to provide the anchor of the secondary market, ensuring the operation of a smooth functioning market. Now that they have been taken over by the government, there is no obvious reason to return them to their mixed public/private status.

We usually want the private sector to take the lead in most areas because we expect private entrepreneurs to be more innovative and willing to take risks. However, we really don't want these institutions to be innovative and risk-taking; we want them to carry through the mundane task of buying up and bundling mortgages and selling them in the secondary market. Private financial firms will still have the opportunity to experiment with new instruments insofar as opportunities develop.

Privatization would also lead to much higher pay for the top executives at these firms. The annual compensation for top executives at both Fannie and Freddie ran into the tens of millions, effectively imposing a tax on mortgages.

In short, privatization of Fannie and Freddie simply adds risk and costs. It provides no obvious additional value.

6. The structure of the Fed should be changed so that all the officials with a direct say in monetary policy are appointed by the president and approved by Congress. The Fed is supposed to act in the public interest, not in the service of the financial industry. It is disturbing that the public is being represented in this debate over the restructuring of the financial industry almost entirely by top figures from the financial industry. This would be comparable to having national policy on the auto industry determined by former top officials with the United Auto Workers. It is difficult to believe that the views of Treasury Secretary Paulson and other government officials from the financial industry are not influenced by their long association with the industry.

This problem should not be worsened by giving the banking industry a direct voice in the conduct of monetary policy, by allowing it to appoint Federal Reserve district bank presidents who take part in open market committee discussions. There should be a strict separation between the conduct of open market policy, which should be done exclusively by people appointed by the president and approved by Congress and the responsibilities of the district bank presidents. The banking industry deserves no special voice in the conduct of monetary policy.

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