WORKING GROUP ON GLOBAL MARKETS
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RESPONSES TO THE CREDIT CRISIS

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Updated November 2008

The ever-evolving plans to cope with the credit meltdown have gone from providing seemingly endless liquidity to mortgage refinancing and on to buying some toxic assets, supporting failing firms and adding equity to hopefully solvent ones. One hesitates to suggest still more, but there are possibilities of merit that have been neglected.

The problem began with US subprime and Alt-A mortgages, but its consequences have now been transmitted far beyond them by derivative pools, credit default swaps and increasing risk aversion, impacting financial institutions generally and creating uncertainty about their solvency. I want here to return to the origins, as a starting point for both current remedies and future reform.

The mortgage crisis has two basic levels: borrowers and mortgage investors. Both politically and economically, there are disputes and numerous proposals for addressing each, but they have to be analyzed separately.

I. Delinquent borrowers

Subprime mortgage lending was to borrowers with weak or incomplete credit histories and weak credit scores, often with little or no downpayment and at low initial interest/payment rates. It markedly increased in volume and decreased in quality from around 2004 on, and delinquency rates have now risen accordingly.

There are many variants of subprime, but a common pattern was to have lower (or even optional) payment schedules for the first 2 or 3 years, followed by a reset to a rate that would pay off the loan over the remaining 28 or 27 years. In providing 'relief' to delinquent borrowers, I would advocate distinguishing between those who made a significant downpayment and those who made little or no investment of their own funds.

The latter group were in substance renting the house for 2 or 3 years, in the expectation that there would be a 10% or 20% appreciation in its value by the end of the initial rate, at which point they would have acquired actual equity in the property and could refinance at a better rate. If not, in most instances they could simply walk away from the house and loan. This amounted to a rental contract with an option to purchase. Relief to this group should consist of their giving the lender a deed in lieu of foreclosure, and receiving an explicit rental agreement and an explicit purchase option. The lender

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would have to write down the value of the original mortgage asset, but would have some cash flow and save foreclosure, eviction, maintenance and immediate resale costs. The borrowers would have lost their gamble, but would be out of pocket very little and would retain their occupancy. And the neighborhood would be spared vacancy externalities.

The first group had saved and risked a real investment, and are better candidates for a government subsidy (which is the direction in which much policy discussion seems to be going). That could take many forms, but an efficient one would be to have their personal out of pocket downpayment matched by a government non-recourse loan, to the extent necessary to bring the mortgage current. Or they could choose the rental/purchase option arrangement as described. This would limit and define a subsidy program, at of course the cost of discrimination in a sense against borrowers who did not 'buy' a more expensive house than they could afford and are not delinquent. All subsidy programs will have this inequity, but it could be lessened by recapture provisions (a subordinated lien) to the extent of the loan received. And it would be compatible with the need to encourage a higher national savings rate.

II. Investors in Mortgage-Backed Securities (MBS)

Subprime and other mortgages were sold by originators to a MBS pool, usually sponsored by a commercial or investment bank, which created a hierarchy of claims (tranches) on its cash flows. The higher tranches might be sold to investors or, along with lower tranches, to a second (CDO) pool, which would repeat the process. The lower tranches of the second pool might then be sold to yet another pool (CDO squared), which might repeat the process yet again, going into a structured investment vehicle (SIV) which issued asset-backed commercial paper.

The result was a structure that became exceedingly complex and opaque. When delinquency writedowns and losses started to really hit the original pool from 2006 on, the credit quality and value of tranches all down the line were deteriorating, but it was nearly impossible to determine by how much. Commercial and investment banks held large amounts of these derivatives on their books (and on off-balance sheet entities on which their reputation was at stake), and counterparties became cautious in their dealings with each other. Other than very short-term lending dropped sharply.

This was initially perceived as a liquidity problem, and the Fed progressively made funds available to banks at lower rates and in larger amounts. But this didn't cure the problem, which wasn't lack of liquidity but fear of possible insolvency by institutions whose asset values were highly uncertain. Counterparties didn't trust the values managements were assigning to MBS and their derivatives. (Ironically, the solution some now advocate is to blame fair value accounting [FAS 157] and urge its suspension or repeal, which would create even greater mistrust of management's numbers.)

So now the Administration is turning to a policy of an initial $250 billion in capital infusions, which would have to be so large that no one would any longer have any reason to be concerned about counterparty insolvency. Purchasing preferred stock in amounts from $25 to $2 billion in nine big banks is not enough to achieve that objective, but (along with guaranteeing new bank debt) it no doubt sends the message that the Treasury will add whatever additional amounts may prove needed—a potentially huge contingent liability. Even if feasible, this too would stop short of addressing the underlying problem—uncertainty about the risk posed by MBS holdings of undeterminable worth.

To attack that problem, there has to be much greater transparency about MBS values and holdings. First: the original pool issues performance reports to its investors, as do pools down the line. (The SEC's Reg. AB contains a list of extensive disclosure requirements for publicly offered asset-backed securities.) In theory, it would be possible to estimate the effect of written-down asset values and current cash flows on the pool's tranches, both at the point of origin and through subsequent derivative pools – IF there were a centralized data base assembling as much information as exists, and making it available on the internet. The task would be far from simple and would take time, but it takes on the core problem and is badly needed, both currently and for future securitizations. A significant part of the needed information is already possessed (but not consolidated) among the three SROs.

Second: institutions holding significant MBS could be required to list publicly all their specific holdings and the value they have assigned to each. Even without better valuation data, this would greatly assist banks in lending to each other. (The SEC can institute disclosure requirements under the APA on an emergency basis, as it recently demonstrated with its short-selling ban.) The disclosure reach of the SEC and banking agencies extends to all commercial banks, investment banks (if any), and publicly traded companies, and foreign regulatory authorities might follow such a lead.

The objective is to put counterparties in a better position to make their own assessments of a trading partner's asset values and solvency. It would also assist the Treasury in deciding which institutions to recapitalize (and which to close). And it might render irrelevant the FAS 157 controversy, before political pressures corrupt accounting standards.