

THE GREAT BAILOUT OF 2008-09

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My task today is to talk about the financial crisis. I only have a short time to talk, so rather than try to give you a comprehensive analysis of events, I'm going to offer some of my own idiosyncratic takes on what has been happening. In addition, I will introduce my own small reform proposal for regulating bank risk taking. So, I'll give you a little bit of news, a little bit of weather, a little bit of everything.

Where are we now? Let us begin with a statement Henry Paulson made six months ago while Bear Stearns was getting bought up by JP Morgan: "I have great, great confidence in our capital markets and in our financial institutions."¹ Six months later, things start looking a little more bleak, and now we are in the business of restoring our financial institutions. That quote from Paulson came the same week that Lehman Brothers, AIG, Fannie Mae, and Freddie Mac all went down. So it was kind of a hard week for the Treasury Secretary. Just earlier this week, the Federal Government agreed to pump up AIG with an additional \$30 billion in taxpayer money right after it reported literally the biggest quarterly loss in history, a \$61.7 billion loss. All told, the government pumped in hundreds of billions of dollars into our financial institutions in four separate interventions, including a hundred eighty billion just to AIG over the past six months.

I would like to discuss four items. First, I want to assess where we are in the great bailout by recapping some of the highlights over the last year. Second, I want to look back a little bit and provide my own idiosyncratic perspective on the causes of our current financial crisis, especially the question: whose fault is it? That is always a nice, popular topic in the press, in the blogosphere, and around the water cooler, so we will see if we can point some fingers at some of the usual suspects. Third, I want to examine subprime

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¹ Statement of Treasury Secretary Henry Paulson, Mar. 16, 2008. *See, e.g., Commentary: White House Caught Napping on Financial Crisis*, CNN.COM, Sept. 24, 2008, <http://www.cnn.com/2008/POLITICS/09/25/campbell.brown.financialcrisis/index.html> (quoting Secretary Paulson).

mortgages. This is kind of a pet issue of mine, and I think the idea has been much maligned in the press, as well as by some judges and academics. I want to make the claim that the subprime mortgage was at least a plausible idea at one time. Finally, I want to look ahead, see where we are going, make some predictions, and suggest a regulatory project for the future that I call “bonding bankers.”

I. THE ECONOMIC BAILOUT OF 2008–2009

First of all, let me just give some of the highlights from the Great Bailout of 2008–09. We started circling the drain about a year ago when Bear Stearns was bought by JP Morgan in 2008, with the Feds coming in to facilitate that deal with a line of credit for JP Morgan Chase. After that, all was quiet for six months until one really bad week in September. On September 7, the government took over Fannie Mae. On September 15, Lehman Brothers filed for bankruptcy. One important consequence was that it left a lot of U.S. hedge funds in the lurch. They had significant funds tied up in Lehman Brothers’ U.K. unit. Apparently, U.S. hedge funds were using Lehman Brothers’ U.K. unit as their prime brokerage—their institutional broker—to take advantage of more lenient margin rules. When the British insolvency administrator took over Lehman, the hedge funds saw their assets frozen, leaving them in the precarious position of not being able to honor share redemptions or otherwise operate. The case has turned out to be a pretty complicated one. If you have been following the press, you know that Alvarez & Marsal, which is running Lehman’s restructuring, has just earned a \$30 million fee for about two-and-a-half months of work—a pretty good gig if you can get it.

Later that week, on September 16, the Federal Reserve took control of AIG. At the time, the Fed put in \$85 billion and took an eighty percent equity stake in AIG. As noted earlier, the government’s stake in AIG is now up to \$180 billion in total.

On October 3, Congress passed the Emergency Economic Stabilization Act (“EESA”). It earmarked \$700 billion to buy bad assets from financial institutions. The idea sounded good: let’s take these bad assets off the books of the banks; let’s buy their mortgages and mortgage-backed securities. If we clean up the banks’ balance sheets and make them transparent, then we will inspire confidence in our banking system. Immediately after passage of the Act, Henry Paulson announced the Troubled Asset Relief Program (“TARP”) a plan to spend the first \$350 billion of emergency funds, and world stock

markets took a big dive because nobody was excited about the program. At the time, the program offered no fix for a major valuation problem: how we are going to value the assets on banks' balance sheets? If we value them at their market value, it might turn out that the banks are insolvent, and that is not a good thing. But if the government overpays for the assets, that presents political perils because the government has then spent too much taxpayer money. So the market didn't like the plan. A week later, Paulson shifted gears and announced that the government would no longer be buying troubled assets. Instead, it would take direct equity stakes in the banks. So Paulson put together his own capital purchase program, instead of troubled asset relief with TARP. Under the new program, the government gets preferred stock for the money it is putting into these financial institutions.

Finally comes February. Just a few weeks ago, the new treasury secretary, Timothy Geithner, announced a plan for TARP II, which we are now going to call "FSP": the Financial Stability Plan—a plan to spend the second half of that EESA money. Under FSP, we have a capital assistance program to purchase convertible preferred stock from the banks. We have a stress test for banks. We also have some troubled asset relief as well as mortgage relief. The basic idea of the stress test is to take the biggest bank holding companies and investigate to see how their capital will hold up in various economic scenarios with troubled asset relief. As far as the troubled asset relief itself, the government is trying to put together public-private partnerships—publicly subsidized funds run by private fund managers—to try to create some kind of market for these toxic assets. Again, we are probably going to run into some valuation questions. If the sale of banks' bad assets results in significantly lower valuations for those assets than is currently reflected on banks' books, it might show the banks to be insolvent. If so, then the banks cannot sell, and we are going to have the same problem we ran up against with TARP I. In terms of mortgage relief, the Treasury has earmarked \$50 billion to reduce monthly mortgage payments, primarily through Fannie Mae and Freddie Mac loan modifications. Just a few days ago, Geithner announced TALF—the "Troubled Assets Loan Facility"—a \$200 billion loan facility to help big investors buy more asset-backed securities. The idea here is to jump start consumer lending and SBA lending by buying up asset-backed securities—securities backed by car loans, credit card receivables, and the like.

As of today, that's where are, and where we've been over the last year.

II. WHO'S TO BLAME?

I want to go back now and take a broader look at where we have been, in order to address a question on everyone's mind: whose fault is this? It's fun to speculate, it's fun to point fingers, and everyone has a favorite perpetrator. So let me run through the usual suspects, and I will give my own take on who we ought to blame.

What about subprime mortgages, an obvious culprit? There was irresponsible lending going on. There was fraud on the part of homebuyers. There was fraud on the part of lenders. There was fraud on the part of appraisers. So the subprime mortgage process looks kind of suspect in any event. What about the greedy bankers on Wall Street? When they were selling these asset-backed securities they did bad diligence, they had sloppy models, and they helped get us into this mess. What about the rating agencies? They were conflicted. They were being paid by the issuers they were rating. What about deregulation? We never got around to regulating hedge funds or private equity funds. At the same time, there are all kinds of opportunities for regulatory arbitrage. Regulation of the financial system is fragmented with overlaps and gaps in regulatory responsibilities. What about Fannie Mae and Freddie Mac? They subsidized risky subprime lending by buying bad loans off the books of subprime lenders. In addition, they fought Congress when it came time to think about tougher lending standards.

That's probably a pretty broad set of the usual suspects, and they all probably played some role. But in isolation, each played what I view to be a relatively small role. In addition, some of this stuff is just not new. Many of these issues we have always had in our financial system.

Let's think about subprime mortgages. They are probably like laws and sausages: you don't want to look too carefully into how they are made because it's probably an ugly process. But at the same time, the dollar value of subprime mortgages is actually relatively small compared to the overall U.S. mortgage market; even smaller when compared to the overall housing value in the United States a few years ago; and even smaller again when compared to the size of the U.S. economy. So by itself, the problem of subprime mortgages probably was not big enough to cause the collapse of the economy.

What about greedy investment bankers? We do have all these problems with diligence on asset-backed securities. On the other hand, greedy bankers have been with us for a long time. That's not a new thing, and to some extent

we depend on greedy bankers to help drive the banking industry. What about conflicts of interest among rating agencies? They have for a while now been paid by the issuers of the rated debt, so again this is not a new thing.

What about deregulation? Trying to regulate the hedge funds as hedge funds is a bit of a tricky business. By that, I mean, not trying to regulate the transactions they were involved in or the securities they were buying, but regulating them as investment entities. The only agency that was interested in trying to regulate them was the SEC, but the SEC's primary focus is on investor protection. So think about the kinds of institutions that get broad SEC oversight: institutions involving large numbers of investors, some of whom might not be sophisticated. It's that kind of entity that the SEC generally regulates. So think about public companies. Think about mutual funds. Hedge fund investors didn't think they needed or wanted this kind of regulatory oversight. Even now, it's really a question of systemic risk, which is really within the purview of the Federal Reserve and the bank regulatory agencies. So, if it is systemic risk we are worried about with hedge funds, the SEC is probably not the right agency for the job.

What about Fannie Mae and Freddie Mac? Well nobody disagrees that they had some role to play in encouraging risky lending because they were buying some risky loans from originators. But Fannie and Freddie weren't really involved with the really ugly stuff, and the magnitude of their involvement doesn't suggest that they could have caused the mess that we're in by themselves.

So, those are the usual suspects, and I claim they don't tell the whole story.

If it's not their fault, then whose fault is it? Here's my pick. Does anybody recognize this picture? [referring to slide depicting National Weather Service satellite photo of weather system]. There is no reason that you should, so I'm going to let you off the hook. This is actually a national weather service satellite photograph of . . . the perfect storm. This is the photo of the 1991 Halloween storm that sank the Andrea Gail, which turned into the best-selling novel, which turned into the George Clooney movie we've all heard about. I think that the meltdown was driven in some part by all the usual suspects that we talk about, and at the same time, it was largely enabled by one major environmental factor: excess liquidity. The world has been *awash* with cash the last few years. We have all kinds of huge pools of cash chasing high-yield returns. So it's not that Wall Street *isn't* greedy, but I-bankers are just out there filling this incredible demand for high-yielding investment products.

So where does this liquidity come from? Well at least a couple of sources. For a long time, from 2001 until about the middle of 2004, the Federal Reserve kept interest rates artificially low in the United States. After September 11, 2001, and after the dot-com bust, the Feds kept interest rates low to keep the economy chugging along. But the rates were so low that at some points during that period they were actually negative in inflation-adjusted terms, and that's one source of all this liquidity that we're seeing. I think it's also fair to say that some of the excess liquidity is a product of the success of the global financial system. We've got better technology, we had lowered the barriers to capital mobility, and, as a result, it's now much easier on a global basis to aggregate capital. We have these huge pools of cash out there looking for investments. We have sovereign wealth funds. We have private funds. We have financial institutions that are all out there hunting for high yields. This global quest for returns, I think, helped drive the creation of fancy derivative products and asset-backed products to meet this unquenchable demand for investments.

III. SUBPRIME MORTGAGES

Let us now turn to subprime mortgages—a little pet issue of mine. I think at the time the idea of subprime lending came up, it was actually a pretty good one, and it is only in the context of all these other factors that subprime mortgages became “ground zero” for the financial crisis. Excess liquidity and rampant securitization allowed the subprime mortgage idea to go off the rails. At least initially, I think it was a plausible idea. Let's try to remember how this came about and what we were after. We were trying to extend the benefits of homeownership to risky borrowers. Who are these borrowers? They are low-income households, they have no down payment funds, they have bad credit history, and they cannot document their income.

So how do we get them into houses? Well, the strategy was to design a mortgage for riskier borrowers that would also protect lenders. So a short-term mortgage was created that really depended on refinancing in order to work for everyone, which in turn largely depended on appreciation in home prices. So, we got these “2/28” and “3/27” Adjustable-Rate Mortgages (“ARMs”). In a 2/28, for example, the interest rate for the first two years is fixed, and the interest rate for the remaining twenty-eight years varies. Nominally, this looks like a thirty-year home loan, but in fact, it is really only a short-term loan because the reset rate on the variable part of the mortgage is pretty high. The

reset rate is so high that it's not very attractive. Note also that this is not a feature solely of subprime mortgages; prime five-year or ten-year ARMS are similarly structured. I have a ten-year ARM on my house now, and I fully expect that as the 10-year fixed rate period comes to an end, I will look to refinance. So this feature of relatively unattractive reset rates is not unique to subprime mortgage.

What this structuring does effectively is to make a nominal thirty-year loan the practical equivalent of a shorter-term loan for the bank, which is a much lower risk for the bank. Subprime loans really are two- and three-year loans. They look like thirty-year loans, but, in fact, they are really short-term loans that give the lender an option to refinance. They reduce the risk for the lender because every two to three years, the lender gets to take a second look at the borrower. Maybe the borrower's financial condition has improved or deteriorated. Maybe the house's value has appreciated. This gives the lender the option to make a new credit decision every two to three years, thereby reducing the lender's risk. And if the house has appreciated or the borrower's financial picture has improved in the interim, the lender refinances and everyone is happy.

The subprime mortgage idea actually worked fine for about eight or nine years. From 1998 to 2006, home price appreciation and short-term financing worked just as planned. Beginning in 2006, however, the wheels started coming off. Home price appreciation peaked in 2006 and declined so steeply that by the third quarter of 2007 there was negative appreciation. Houses are losing value in 2007. This timing is not so good because we were just hitting the peak of subprime lending. During 2005 and 2006, subprime lending peaked, accounting for twenty-five percent of U.S. mortgage loans. And there are actually a lot of dollars at stake. Originations hit a peak in 2005 at \$625 billion. In 2006, the dollar amount of outstanding subprime mortgage debt peaked at over \$1.2 trillion.

While that's a lot of dollars outstanding, let's put that in perspective. As earlier noted, subprime debt is a relatively small piece of overall mortgage debt, it was an even smaller piece of overall housing values in the U.S. at the time, and, of course, it is an even smaller piece of the economy as a whole. So by itself, the subprime mortgage boom was not big enough to bring down the economy. It's only when we combine it with securitization, supersized leverage, and excess liquidity that we get this ugly story that we are in now.

IV. BONDING BANKERS

So, here we are. What's next? Well, let's talk a little bit about the future. First, what about nationalizing the banks? Technically, that's not the future, it's the present because Citibank is now sixty percent owned by the government. They just agreed to swap preferred equity for common stock. So, the government is now a major player in Citigroup. Expect to see more of that. Second, what about regulating financial institutions? Probably for systemic risk purposes we are going to see an extension of safety and soundness oversight to entities like hedge funds and private equity firms to the extent that there's a political decision that there were important systemic consequences in the kinds of investments involved.

Finally, let me introduce my own idea on bonding bankers. I want to tinker with executive compensation at banks to try to reduce risk-taking by bank managers. Let me just run through some of the steps. Bank deposit insurance creates moral hazard. Deposit insurance effectively allows banks to take certain kinds of risks that ordinary companies can't take. With ordinary companies, creditors actually write contracts that include constraints on risk taking, and those creditors monitor their borrower companies' risk taking decisions. But banks are generally not subject to that discipline. Banks' major creditors are their depositors. Depositors don't care about bank risk taking because their deposits are insured. And depositors don't have contracts that constrain bank risk taking. Banks don't have private monitors; they have public regulators. But regulators may not be as careful about monitoring as folks with their own money on the line.

My idea is to combine market discipline with a pay mechanism. Pay for performance has been all the rage in the recent past. It means paying managers with stock and other kinds of equity-based compensation, in order to align their incentives with the stockholders' and to increase share value. This might be a good idea for companies generally, but it's probably not a great idea for banks. When you pay managers of banks with equity, you increase their risk-taking incentives by giving them a direct equity stake in the upside payoff from taking big risks. Instead, I suggest market discipline. The way to impose market discipline is to require banks to issue publicly-traded debt securities whose repayment is subordinated to the banks' deposit liabilities. This makes the trading of the debt securities very sensitive to the banks' risk-taking. If we include those securities in the pay packages of the banks' executives, they effectively get paid for less risky performance. This gives executives a direct

incentive to worry about risk because excessive risk-taking gets punished in the public debt markets, which would also directly affect the wealth of the executives through their holdings of debt securities.

So, basically that's where we are, that's where we have been, and I think, more or less, this is where we are going.

