ASPATORE SPECIAL REPORT

The Impact of the Obama Administration's Financial Crisis Policies

An Immediate Look at the Legal, Governmental, and Economic Ramifications of President-Elect Obama's Potential Solutions to the Recession

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President-Elect Obama's Actions on the Financial Crisis

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Current Action

During the presidential campaign, President-elect Obama did not address the financial crisis, per se, in any detail. He focused on what he would do to the economy structurally through trade policy, job creation, tax reform, and income redistribution. But other than raising the alarm about the "worst financial crisis since the depression" he did not address the financial crisis. Indeed, I think neither candidate addressed the financial crisis directly. They both allowed the Treasury to deal with it during the campaign.

Subsequent to his election, Obama's people have been in contact with the people in the Bush Administration, and it seems that the two administrations are now talking to each other and trying to address the problem with a common front. The appointment of Tim Geithner as Secretary of Treasury demonstrates Obama's understanding of the need for continuity in dealing with these issues. However, I do not recollect any real attempt to deal with the crisis directly, other than making a few comments to slow down the foreclosure process, which is a symptom and not a cause. Obama does realize that he is not yet the president, so it would be premature for him to offer too many concrete suggestions.

He has won the election, but Mr. Obama has not yet addressed the root causes of the problems. He has addressed some of the symptoms, and has talked generally about the need for fiscal stimulus and foreclosure relief, but he hasn't made any concrete proposals. He has repeatedly called for substantial fiscal stimulus, especially for massive infrastructure investments. To the extent that this stimulus helps stabilize the economy, it will be helpful. He hasn't endorsed any particular solution on foreclosure relief—and many have been proposed. Rather, he has continued to call for helping homeowners directly in some fashion. The most concrete way in which Mr. Obama has proposed to deal with the crisis is through continuity in dealing with the problem by reaching out to Geithner to be his Secretary of Treasury.

What I would want him to do is to announce a comprehensive analysis of the problem and a set of proposals that deals with all of the causes of the crisis. What I would hope we don't see is a continuation of the hit-or-miss

approach that the Troubled Asset Relief Program (TARP) has become. That would be a major mistake.

TARP wasn't really given a chance to succeed. When it was first proposed, TARP was designed to deal with the lack of liquidity for certain assets in the banking system. It was designed to help quantify the economic loss in the system and create a mechanism to allow the banks to liquefy their hard to value assets. Almost immediately, it was changed from buying bad assets to buying stock in the banks. The focus thus shifted from liquidity to solvency and capital adequacy. This shift reflected the accurate observation that buying equity in the banks would give them more lending capacity. Unfortunately, banks didn't need lending capacity; they needed creditworthy customers and stability on the asset side. Then TARP shifted again, and became a financing program. Cheap capital was made available to any qualified financial institution that needed it. As such, TARP became a substitute for the discipline of the capital markets and certain financial institutions bought banks just to get access to TARP funds. Finally, TARP became a mechanism for providing consumer credit. So now, it is a program for stimulus. Each of these shifts reflected political forces, and the constant shifting of its goals and methods caused more problems than it solved. Obama must avoid a continuation of dealing with the credit freeze reactively.

A second mistake—and possibly an even larger one—would be to try to use this crisis as a way to achieve his redistribution or other political goals. What is going on in the credit markets is a systemic problem. It needs to be addressed that way.

What needs to be done here is to separate the economic issues from the political issues.
The economic issues have to be quantified and addressed first, and then the political issues can be addressed. While this approach may be harder politically since the winners and losers are clearly identified, I believe it would lead to a better outcome; one that will be easier to explain to the American people.

For example, in the debate about foreclosure relief, the Bush Administration and the Obama Administration have both been upset about

the decline in housing prices. Both administrations have looked for a way to slow down the fall in housing prices. Yet housing prices have to fall to a level where housing is affordable. Nothing can be done to stop that, and all the policy attempts to date to prevent housing prices from falling merely exacerbate the problem.

The right policy is to allow housing prices to fall, and then if you want to protect or compensate people whose houses declined in value, do that directly. Do not try to create a policy that mixes those two goals. Housing prices are going to fall; the right policy is to let them fall. If you want to prevent foreclosures and people from being thrown out of their houses, that is different. Unfortunately, there is no easy or completely equitable way to do deal with foreclosures, and any policy that addresses the issue indirectly will have unanticipated consequences. This is especially true if the mechanism for preventing foreclosures is an indirect, albeit general, economic policy. The policy response for a homeowner who bought a house with no money down on an overstated and undocumented income may be very different from that for the homeowner who made a down payment of 20 percent, but has lost his job due to the recession.

Once housing prices have fallen to a level where they are generally affordable, people will buy them, banks will be able to lend against them, and foreclosures will stop. This would be a desirable result, both in the short and the long run. The political decision to protect homeowners against the consequences of bad investment decisions or a deteriorating economic environment should not be mixed with the economic need to allow houses to fall to a level where they become affordable. The biggest mistake will be not to separate the economic from the political consequences here, and try to create policies that disguise the economic problem.

Possible Action

At the moment, Mr. Obama has no authority, so he cannot really do anything about the current crisis. I think the decision of the Bush Administration to invite the Obama Administration to be part of the process going forward has been constructive as it shows that both parties realize the seriousness of the situation.

As noted above, Obama's announcements to date regarding his program have focused largely on the need for massive fiscal stimulus. But there is more to the credit crisis than inadequate aggregate domestic demand. Unless Obama can give us a more comprehensive analysis of the problem and a set of solutions to deal with all of the issues, then his solution will be no different from that of the Bush Administration.

Here is one way to look at the situation. There are three sets of problems to be addressed: excess consumption in the U.S.; over-reliance on exports for economic growth in developing economies, and inadequate regulation of financial institutions globally. These are the root causes of the explosion of liquidity in the U.S. that manifested itself in the housing bubble, the bursting of which was the event that brought about the crisis in the capital markets and the subsequent problems in the U.S. and global economies.

Consider the fact that many of the economies in the developing world are running surpluses and generating "savings" in excess of their capacity to invest. These excess savings created two problems. First, in a Keynesian sense, they were deflationary; in order to overcome the fiscal drag they created, some entity had to go into a deficit condition. Traditionally, a country's government plays that role. This time, it was the U.S. consumer. The second problem was that excess liquidity drives down returns. Savers thus engaged in a global scramble for yield. Savers everywhere were impacted by these events, and, when offered higher returns on U.S. real estate related investments, were unable to resist. Thus, financing for the housing bubble was assured.

For a number of years, the U.S. consumer was happy to play this role. Imports surged, but brought with them lower prices. Freed from the burden of savings, the U.S. went on a massive buying spree, and the U.S. economy became substantially more leveraged than it had been in the past. Yet nobody blew the whistle, in part because the yields available on U.S. paper were so attractive. Many people noticed the increased gearing of the U.S. economy and the U.S. consumer, but nobody wanted to stop dancing because the music continued to play.

Ultimately, however, the U.S. consumer was unable to support the obligations it was incurring. Put simply, liabilities were increasing much

faster than incomes. At some point, creditors and others had to notice that we were over levered. Housing became the case in point when subprime borrowers started missing payments in record numbers—many of them within the first three months of buying their homes. It wasn't too long before housing prices had increased 30 percent or more relative to incomes, and it became clear that those prices could not be supported by the incomes of the homeowners. At that point, the music stopped, and many people were left without seats.

How do you solve these issues? You need policies that will shift the composition of U.S. GDP a little bit more toward investment, and a little bit less toward consumption. After all, the principal way to can increase per capita income is to invest in the work force. To increase our income-generating capabilities, we must invest more and consume less. But if the U.S. takes those actions, it will be deflationary for the rest of the world. As a result, countries outside of the U.S. have to make a shift in the opposite direction, to focus a bit more on domestic consumption and a little bit less on export-led growth.

The last piece of the puzzle has to deal with the regulatory system. Put simply, the financial system has to be re-regulated in a way in which the players cannot continually evade the capital requirements that regulators thought they had in place. For example, back up lines of credit, which support third party obligations, need to have a capital charge whether they are drawn or not. Collateral requirements on mark-to-market assets have to be augmented by capital charges for those times in which markets are not liquid. In addition, the regulators have to be charged with enhanced oversight on the degree of leverage in the system, and no longer allowing financial innovation to pile leverage on the system in a way that is inappropriate.

Including the other countries affected by this crisis clearly has to be a coordinated effort. China and India have each recently announced large domestic stimulus programs. These are very good steps in the right direction. If you read Treasury Secretary Henry Paulsen's speech of November 12, he talked about the need to deal with the global imbalances. Getting the rest of the world to realize this is a global problem, and that the

economies of the world are integrated, is important in helping the world come to a more appropriate global fiscal policy.

It is also very important that we eliminate the forum shopping for regulatory policies, where financial institutions are able to go from one country to another looking for less regulation and more support. Of course, you always go where you can get the most lenient regulation. Foreign relations are very important, and have to be reconsidered as encompassing economic as well as a political, security and human rights issues.

Implications

My advice to those most affected by these coming changes is to deal with the spirit, if not the letter of the law and the regulations. Recognize that the regulations are necessarily imperfect. The mindset must be that you should not push to the edges of existing regulations, but try to live with what they are designed to do. That advice is difficult, because people feel an obligation to take advantage of whatever loopholes are created in the environment. But maybe we would have lost fewer financial firms if they had taken this point of view.

My second piece advice is that one outcome of this crisis has to be improved understanding of enterprise risks, and increased disclosure of those risks. How can it be that nobody—not even its risk managers or executive officers—understood the extent of AIG's obligations under credit default swaps or its stock lending business? Indeed, it seems that the Treasury has not yet sorted out these obligations!

This lack of disclosure is likely to create legal exposure for boards. Boards will no longer be able to rely solely on the advice of their experts. They will have to go beyond just asking the experts what the answer is, and do some probing of their own. Boards are often advised to deal with their fiduciary obligations by relying on the advice of experts. If you read the model charter for a New York Stock Exchange company, it says boards are allowed to rely on their experts. The standard should be higher than that. Directors should be required to have a reason for that reliance. There will clearly be a great deal of litigation that comes out of the credit crisis that

revolves around these issues. Was the board asleep when this leverage was put on the balance sheets?

On the regulatory side, we have to rethink how banks and securities firms are regulated. In hindsight, some changes made under both the Bush and Clinton administrations were inappropriate. These changes need to be rethought. For example, the elimination of the net capital rules on securities firms, which allowed them to increase their leverage from fifteen to twenty times to thirty to forty times clearly was inappropriate. It allowed those firms to take risks they could not absorb when the world moved against them. On the banking side, the Basle II framework has to be considerably rethought, because it allows the fox to guard the henhouse, as it were. Can you really rely on a bank to specify what capital it needs for its operations? The legislation that declared that credit default swaps are exempt from both banking and insurance regulation clearly needs to be rethought.

The banking system evolved in such a way that banks were allowed to provide indirect credit support to leveraged entities without having any capital charges. That is inappropriate since, economically, the banks assumed those obligations in certain circumstances. The regulatory environment has to change in a way such that every time a bank or a securities firm incurs a contingent obligation, capital has to be deployed against that, so there is an economic brake on the amount of leverage they incur.

The existing players will resist these regulatory reforms. The process will be further complicated by the existence of state regulations in certain areas, notably insurance. There will be the normal political tussle between federal and state jurisdictions over some of these enterprises. I think you will have to move to a single regulator for the U.S. financial environment, at least where credit is concerned. You should not be able to have forum shopping domestically, in terms of depository institutions.

We have moved to a world where the government is guaranteeing all of the liabilities in the financial system. The question is: What is our exit plan for TARP, and how are we going to get savers to absorb the risk in their decisions, rather than rely on the government to provide all the support?

Howard Newman is the president and chief executive officer of Pine Brook. Mr. Newman was with Warburg Pincus from 1984 to 2006, where he was most recently vice chairman and senior adviser and a senior member of Warburg's management and investment operations. Throughout his career, he led or co-led Warburg Pincus' energy, financial services, media, real estate, and general investment practices, and served on Warburg's Ventures Operating Committee, Executive Management Group, Investment Policy Committee, and Economic Advisory Council. Mr. Newman invested in forty-seven companies while at Warburg, including Newfield Exploration Company, RenaissanceRe Holdings Ltd., and Mellon Bank Corporation.

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