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Preventing the Next Subprime Crisis

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While most of the attention was focused on the recent sale of Bear Stearns and Federal Reserve actions to shore up financial markets, federal financial regulators agreed upon actions designed to prevent the next subprime mortgage crisis. If implemented properly, the March 13 report of the President's Working Group on Financial Markets[1] will help toward that end.

A key factor in evaluating the report is understanding which problem it seeks to correct. The subprime mortgage crisis requires responses to three problems: the thousands of individuals who may lose their homes due to unaffordable mortgage payments; the stresses in the overall financial system caused by huge losses on investments backed by these mortgages; and the credit practices surrounding the granting of mortgages, their packaging into structured investments, and the evaluation of those financial instruments. The report focuses exclusively upon the third area.

Senator Christopher Dodd (D–CT) and Representative Barney Frank (D–MA) have proposed legislation calling for a massive refinancing of subprime mortgages through the Federal Housing Administration (FHA). In contrast, the March 13 report seeks to supervise and monitor the credit markets rather than to micromanage them with a series of heavy-handed new laws. The report's emphasis is on transparency and disclosure, and almost all of its recommendations can be implemented using existing laws or private-sector initiatives. With very few exceptions, most of its recommendations are more a matter of improving existing regulation than of imposing new ones.

Improved Credit Ratings. The report calls for credit rating agencies to improve the way in which they "grade" securities. Currently, both traditional securities and structured credit products are graded the same way. Structured credit products are sophisticated and often highly complex packages that include such ingredients as tranches (pieces) of mortgages representing a specific level of repayment risk. They are designed to meet specific investor needs.

When credit rating agencies gave structured credit products ratings that appeared to be the same as those given to traditional securities, investors assumed that they had received the same level of scrutiny and carried an equivalent risk level. In fact, the analysis was often based on models with faulty assumptions (such as continuously rising housing prices) and greatly underestimated the actual risk. Since the model and assumptions used to evaluate structured credit products were not disclosed, investors were unable to evaluate properly either the securities or the ratings given to them.

In response, the working group recommends that credit rating agencies make their processes

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more transparent. This includes publishing sufficient information about the assumptions underlying their credit rating models and methodologies and clearly differentiating the ratings given to complex products from those given to traditional instruments. In addition, the report encourages formal and periodic reviews of those assumptions. Investors would be told to what extent the agencies had examined the actual assets that were securitized to create the structured credit products. In the case of mortgage-related securities, this would indicate whether the actual mortgages were credit-worthy and properly originated.

Many of these improvements are already being implemented by the credit rating agencies themselves. However, to ensure that these reforms continue, the agencies would set up a private-sector group with representatives from issuers, investors, and underwriters to monitor the situation and develop recommendations for additional actions to improve transparency, the actual ratings, and the way that ratings are used.

Improving Mortgage Origination. One factor in the current upheaval is that mortgages were made to homebuyers who normally would not qualify for them and were presented as being of much higher quality than they actually were. While much attention has focused on underwriting problems in the subprime market, the fact is that credit standards were relaxed for most classes of loans with the result that home purchasers found themselves in mortgages that were inappropriate for their financial circumstances, and underwriters of mortgage-backed securities purchased mortgages that were far riskier than they seemed.

To answer this problem, the report recommends better underwriting standards by originators of mortgages. A key recommendation is better oversight of mortgage brokers by states and federal regulators, including state licensing of mortgage brokers who are currently unsupervised. This is an important step that would address a consistent weakness in mortgage originations. Licensing requirements that are properly enforced would help to improve the quality of the mortgages that those brokers create.

In addition, the report recommends that oversight of all mortgage originators should be more consistent, meet certain minimum standards, and include effective enforcement mechanisms. This would improve existing regulation rather than add a new layer that would only complicate matters further.

Finally, the report recommends that the Federal Reserve issue stronger consumer-protection rules that include better disclosure of how affordable different types of mortgages will be in different scenarios over the life of the loan and thereby enable consumers to better compare their mortgage to alternate products. States and federal regulators would coordinate the enforcement of these rules so that they apply to all types of mortgage originators.

Improved Risk Management and Regulation. The report also addresses poor risk management practices within financial institutions that both purchased and originated sophisticated mortgage-related investments. One of the more disturbing revelations of the subprime crisis is that major financial institutions are unable to estimate their actual exposure to losses resulting from these types of securities accurately. The causes of this range from improper understanding of the actual risk associated with individual investments to the inability to aggregate the holdings of various investments properly across all of a firm's business lines. As a result, financial institutions have found themselves far more exposed to risk and potential liquidity problems than expected, especially as credit conditions have deteriorated.

Federal regulators will take rapid steps to require firms to improve their management information systems so that this information will be readily available. They will also ensure that firms have better governance systems to improve their risk management practices. Compensation practices should encourage individuals to conform to firm guidelines rather than ignore or circumvent them. Finally,

1. The President's Working Group on Financial Markets includes the Treasury Department, Federal Reserve, Securities and Exchange Commission, and Commodity Futures Trading Commission.

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firms will be required to establish and meet liquidity and capital standards that are sufficiently strict to enable the firm to survive even in times of severe systemic stress.

Improved firm risk management will be supplemented by regulatory improvements designed to encourage firms to improve both capital and liquidity cushions and enhanced guidance for the risk associated with firms that distribute sophisticated financial products to investors or other sellers. Equally important are recommendations for improved disclosure of off–balance sheet obligations, including the actual value of complex or illiquid investments. Federal regulators will also study the role of accounting standards in creating the current financial instability.

While most of the recommendations apply solely to U.S. financial regulations, a significant number should also result in an international effort to improve capital standards and regulation. Such improvements would enable investors to do a better job of evaluating the financial institution's true condition and give regulators a better understanding of the risk that a particular institution could pose to the financial system.

Conclusion. If properly implemented, the recommendations of the report of the President's Working Group on Financial Markets should go a long way toward preventing financial crises like the current subprime mortgage problems. This would have a longer-term impact than the misguided, FHA-based response proposed by Senator Dodd and Representative Frank.

However, since the report is nothing more than a series of general guidelines and statements, how its recommendations are implemented will be extremely important. Implementation needs to be both consistent among the various state and federal regulators and balanced.

While most of the report's recommendations can be put into effect under existing laws, it will be important to watch carefully for congressional attempts to use them to justify harsh new laws that could end up crippling credit markets. The key is to learn from recent events and to use those lessons to ensure that the current crisis is not repeated.

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