It's Time for New Ideas

By Ethan Penner

The financial dislocation of 2008 is in the record books, and the costs of righting our economic ship will be large. It is essential that we as a society learn the lessons of this experience and re-work our financial system so as to prevent recurrence. The knee jerk reaction has been to find scapegoats, call for more and better regulation, and dream up patchwork remedies that mostly involve borrowing from the future to save the present.

Through a program called TARP, which thus far has truly epitomized the term "knee jerk," the U.S. government has sunk $350B into our nation's lending institutions in the hope that it would stimulate new lending that would lift our economy. To say that this did not work would be a gross understatement. Not only have the recipients of TARP dollars not extended much in the way of new credit, but their balance sheets have continued to erode with many of the largest institutions announcing continued quarterly losses and writedowns in the many billions of dollars. All the while, foreclosures have proceeded to grow at an alarming pace, unemployment rates are escalating, credit card debt is high, and the consumer is looking shakier every day.

The correct response of our government should be to make real change such that we have a financial system with enough leverage to insure a functioning and vibrant economy, but is structured in a manner that greatly reduces the risks to the taxpayer. With that worthy goal in mind, there is a single simple step that I believe would lead to massive changes that would put our financial industry on much sounder footing. But before I get to that let's take a look at the current state of our lending industry with a clearer focus.

Deconstructing Banking

We now live in a time when loans or securities backed by loans in nearly every arena, including home mortgages, commercial real estate loans, corporate loans, consumer loans, are valued at significant discounts to their face values, reflecting their poor credit quality. In fact, delinquencies and defaults from loans originated during 2005-2008 will surely be the worst of any vintage of loans in modern history. The important and simple conclusion to draw from this is that our current system of originating creditworthy loans does not work and needs to be revamped.

Our two main sources of credit have been banks and securitization-based lenders, or originators who make loans and then package them into securities and re-sell them. While much of the early blame was placed at the feet of the latter group, banks holding large portfolios of loans are in the process of realizing a similar fate to those who bought loan-backed securities. Each of these paths of origination needs to be re-thought and re-worked, but the answers will most assuredly not lie in simply imposing heavier regulation on the current model. You see, the best drivers in the world need to drive the best cars. Our current financial system is akin to the Edsel and it needs to be replaced with a newer, better model.

Starting with banks, it's important to see them for what they are. They are essentially operating in two very different businesses. The first is providing cash management and cash transactional services such as checking and savings accounts and money wires. This is a very important function, and to insure that this system works smoothly we taxpayers allow the government to grant our guarantee through the FDIC for essentially all of the cash in this system. The second, which has absolutely nothing to do with the first and is where all of the systemic risk resides, is the business of making and owning loans. That leads me to asking a few heretical questions: Why do these two unrelated businesses necessarily reside in the same company? Why should these bank entities, because of their role in our cash management system, be advantaged in the lending business through the extension of the taxpayer-backed FDIC guarantee which provides them with a cheaper cost of funds than other lenders?

The truth is, if we granted banks our taxpayer-backed FDIC guarantee so that our money was safe while they performed the cash management business, we ought to limit the credit risk they took with those funds, perhaps restricting their investments of our cash to U.S. government guaranteed securities so that we haven't inadvertently underwritten risk in lending we don't need to or want to. In fact, I would postulate that by untangling the cash management business, with its robust and predictable earnings, from the lending business, which is always the cause of bank losses, banks' franchise values would actually improve.

Democratize our Taxpayer-backed Government Guarantee

Of course, our nation needs a healthy system of lending and there is real merit to utilizing the taxpayer guarantee to create and support such a market, but as a taxpayer I'd like to be better protected from losses than I am through the current banking system, where the protection from loss is thin (6% regulatory equity capital requirement) and the ability to actually understand the risk in these opaque entities is practically nil.

Instead, I'd propose a system whereby any loan originated in the U.S., by a bank's lending subsidiary or a non-bank entity, can be bifurcated into two classes, an 80% senior class and a 20% junior class, which junior class would bear any and all losses associated with that loan until it was wiped out entirely. Contingent upon the originating entity contractually committing to own the risky junior class to maturity, the government would place its guarantee on the protected senior class, thus making it very safe and very liquid for bond investors.

There would naturally be a fee paid to the government by the loan originators for this guarantee, but I'd recommend tying the fee to each lender's historical loan performance (adjusted annually), such that the worst third of the lenders by loan performance essentially paid for most of the premiums. With all lenders having equal access to this guarantee, and thus identical cost of funds for 80% of their capital, it would be the cost of funds for their retained 20% stake in their originations combined with their share of the insurance guarantee fee that would determine which lender will be more price competitive, and thus garner larger market share. So, in this system it would be the best quality lenders, paying lower guarantee fees and attracting more investor capital at a lower cost for its lender equity, who would become our nation's largest lenders. Thus, it would be these "best of breed" lenders who would be the nation's largest lenders and to whom we'd have most of our taxpayer risk exposed to.

Under this system, the taxpayer's risk profile would be markedly improved as the 6% bank equity protection from loss would now be increased to 20% (the retained junior interest on each loan guaranteed), and, importantly, the loan originator would have significant skin in the game (the 20% riskiest piece) for the life of the loan which should impose the necessary discipline for lenders to make good loans and turn away bad ones. In this system, access to our taxpayer guarantee would be democratized - the largest lenders, and thus the largest users of our guarantee, would be the best lenders instead of the lenders anointed by the government.

This solution would also clean up the mess in the securitization business since the government guarantee will be pervasive. As a result, the bond market will be comprised nearly exclusively of government guaranteed securities, with the credit risk instead residing in the companies that originate loans and hold the junior 20% classes. Happily, there would be no more need for second-guessing the rating agencies. And, with a plentiful supply of government guaranteed securities, the cash management focused banks could invest their cash exclusively into these, and since their balance sheets would thus have zero credit risk we could allow them to hold very little capital, which would make their return on equity look quite spectacular.

Naysayers might say that requiring 20% equity in the lending business would be over-correcting from the super-high systemic leverage that we have experienced this past decade, and that we would not have enough credit in the system to avoid massive deflation and a depression. The answer to that is that the structure of that 20% can be a combination of subordinated debt, preferred stock, as well as equity, and thus leverage levels can be significantly higher than the 4:1 ratio that the 20% retention implies. Importantly, the incremental leverage and its attendant risks would reside exclusively in the private sector and not at the expense of the taxpayer's protected position.

Another beneficial by-product of this change would be the modification to compensation schemes for those in the lending business. Much of the bad lending in the past can be blamed on mis-aligned incentives, especially for securitizers, whereby a loan was made and sold and the profit of that loan was present-valued, creating a large gain from which a large bonus could be paid, with no strings attached to the long-term performance of the loan. In the world whereby each lender must retain the junior 20% stake in loans, there is simply no lump sum profit at origination from which to pay bonuses. Bonuses would thus be paid from the only source available which would be the long term cash flow performance of the loans. This would further encourage a system of good credit underwriting.

Regulators would still have work to do but with better risk protection for taxpayers and better alignment of interest on the part of the lenders their goals of keeping us out of trouble would now be much easier to achieve. They'd need to make sure that the bank's cash management operations were functioning properly, and shut down those entities that were not capable. They would also need to oversee financial reporting, require real transparency and integrity, and insure that these institutions were properly capitalized and in fact retaining the junior pieces of their loans.

Oh, and with bank deposits now isolated from the business of credit risk management, credit default swaps would no longer be something we taxpayers would have to worry about.

We Need New Banks/Lenders

There is another major problem facing our government today. Thus far, all of its new capital has been funneled through the nation's largest banks and lending institutions. Sadly, most of these institutions are mired with massive legacy portfolios that take up the majority of their resources: both human and capital. There has been great frustration and anger that these lenders who have received TARP dollars and other guarantees with the expressed desire to have them extend new credit into our moribund economy have not done so. The sad reality is that with the distractions of these legacy portfolios that are deeply underwater these lenders have been hamstrung and thus unable to extend new credits.

What our nation needs today are new, well-capitalized lending institutions with no legacy portfolios burdening them, capable of extending new credit and focusing 100% of their energies on new business. Thus, I propose that the government take the remaining TARP dollars, and offer it to equity investors in newly formed lending entities as long-term participating preferred stock that would count as regulatory capital. In this plan, equity investors would invest real risk capital, leveraging their common equity with the TARP preferred stock at say an 8:1 level, such that $44 billion of new equity would be paired with the remaining $350 billion of TARP dollars to create $394 billion of fresh leverage-able bank regulatory capital, which applying even the conservative low leverage ratio of 4:1 that I suggested earlier would create nearly $2 Trillion of fresh lending capacity for our system.

By utilizing TARP dollars in this manner the two most critical goals would be accomplished: new lending capacity would be created to invigorate our economic recovery and the taxpayer would be in a protected position by virtue of the infusion of private equity capital that would bear all the first loss risk. In fact, with a coupon of say 6% and warrants for 20% of the new banks, the economic return for the taxpayers not to mention that of the private equity investors, would be compelling.

Marking-to-Market And The Foreclosure Problem

Finally, the slow bleed going on at our nation's financial institutions, with quarterly write-downs of asset values, is a reflection that many have resisted an honest marking-to-market of their loan inventories, perhaps because doing so would mean having to admit insolvency. Indeed, there are many who oppose having lenders mark their inventories to market at all, blaming much of the damage done in this down cycle on this accounting provision. Yet, it is imperative to understand that homeowners certainly do mark their homes to market on a regular basis, and without a marking to market of the associated liability, the mortgage, there will not be any resolution to the current foreclosure crisis.

To illustrate, if a homeowner has purchased a home for $400,000, has a $360,000 mortgage and now knows that his home is worth only $200,000, he is highly likely to let the home go into foreclosure unless the mortgage's principal balance is reduced to an amount below the home's value. Modifying a borrower's payment schedule, as has been the

preference of lending community and the FDIC has not and will not change the borrower's motivations or calculus.
It must be remembered in these days of foreclosure that a home has no intrinsic value to a lender as it has little to no income generating capacity. For it to have value it must be sold to a resident-owner. So, in the example above the $360,000 mortgage must be written down to no more than $180,000 before the homeowner community, knowing the home is worth no more than $200,000 would be induced to own the encumbered home. In essence, if the equity holder is marking to market, the debt holder must too before things clear. We will not see a bottom in housing prices and an end to our foreclosure epidemic until lenders who own mortgage loans are compelled to mark their loans to market accurately. If it means that institutions fail, then the plan to utilize the remaining TARP dollars to create new institutions would become even more relevant.