The Future of Capital in Capitalism:
Can Banking Withstand New Securitization Rules?

Remarks by

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It is a pleasure to be back with all of you again. As general counsel of the nation's biggest banks, I'll bet you've been a bit busy since we met last October.

You've asked me to review strategic issues arising from changing federal law and rule. There's more than a little to talk about, but I'll focus today on asset securitization. I think it epitomizes a financial activity on which each of your banks and the markets have depended in recent years that is now undergoing a profound rewrite in large part due to legislative and regulatory factors. Securitization is critical to functioning capital markets, making these policy issues of critical importance to the recovery. It's also a very apt case history of the degree to which policy factors – all too often ignored in strategic planning – have direct bottom-line impact, a case history I think applies to many other lines of business at least as important to each of your banks.

It's also important now to focus on securitization from a public-policy point of view. A lot of attention these days is on what I'll grandly call the "future of capitalism." The unparalleled scope of federal involvement in the U.S. economy has led to important discussions of the degree to which the raft of programs put in place points to a far greater government role in activities once left exclusively to private institutions. Asset securitization is an arena in which the federal government has long played an out-sized role, especially in mortgages because of government agencies like the Federal Housing Administration and the government-sponsored enterprises (GSEs). Mortgage lenders, insurers and securitizers have long had to reckon with government policy as a basic fact of life in defining the market they can serve, the products they can offer and even the prices they can charge. Massive as that role was, though, it's dwarfed by the one Fannie Mae and Freddie Mac now play in residential mortgages in conservatorship. It's also subsumed in even more U.S. Government (USG) programs for mortgages and other assets – for example, the Term Asset-Backed Securities Loan Facility (TALF) and the Public-Private Investment Program (PPIP). These programs focus not only on residential mortgages, but also on auto loans, credit cards, commercial mortgages and other asset classes. If they stay in place or remain in a new form, the USG role in financial markets will be profoundly altered.

The Critical Capital Question

As with almost every other line of business at your banks, securitization will be dramatically affected by changing regulatory-capital requirements. How much capital is charged to whom where in the origination and securitization process is a game-changer for retail finance and the capital markets, affecting issues ranging from the relative competitiveness of smaller institutions to the rebirth of non-bank giant investment houses. Along the way, the future for monoline credit insurers, credit ratings agencies and other entities intimately involved in securitization will also be decided.

First, though, what are the pending capital standards? I've talked to this group since at least 2000 about Basel II, and I suspect some of you are hoping I don't start that all over again. But, here goes because it counts.

For all these years, regulatory capital has all too often been viewed as the purview of junior risk managers despite its profound strategic impact. Now, though, President Obama and the rest of the heads of state at the G-20 summit have themselves weighed into the debate and have set new policies – one of which is to bind the U.S. to new capital standards by 2011. This has, I hope, settled the debate and made very clear that capital is a corner-office concern.

The G-20 also pounced on securitization, with one aspect of its new directive intertwined with the capital regulations. One conclusion the G-20 has drawn from the current crisis is that incentive alignment in securitization was way out of whack. That is, originators and issuers could make and take loans with nary a thought to the borrowers at the bottom or the investors at the end of the securitization process. Because originators and securitizers took no risk, they could and did package almost anything and – with the help of the credit ratings agencies – sell it to even the most risk-averse institutional investors.

To cure this incentive misalignment, policy-makers have focused on requiring risk retention throughout the securitization process. The European Union (EU) has already taken action on this, requiring a flat five percent material risk protection. The Obama Administration reform package includes a variation on this – five-percent risk retention and no hedging, as in the EU measure, but broad authority for the banking agencies to exempt different types of asset-backed securities (ABS) or ABS structures.

The Administration proposal is an important and constructive proposal – if the EU approach were followed in the U.S., I think asset securitization would take far longer to restart and macroeconomic recovery would sharply slow. An array of retail and wholesale credit markets are now dependent on securitization – in fact, so dependent that the Fed and Treasury have stepped in with the USG facilities I'll turn to again in a moment. Without securitization, consumers will need to rethink their house, car and auto loans and commercial real estate will get even more credit-scarce than it already is. However, even with the Obama approach, different market segments will be winners or losers depending on who gets what exemption.

Bringing It Back on the Books

Risk-retention requirements are not, however, the only major regulatory initiative that threatens securitization. Another phenomenon results from new FASB accounting standards requiring consolidation of a wide array of off-balance sheet trusts and similar structures long associated with ABS. Much in the FASB rule, like a new Basel standard, reflects the newly-understood liquidity and credit risk of off-balance sheet, complex structures like structured investment vehicles (SIVs) that brought more than a few big banks low. Of particular concern to FASB and bank regulators were the non-contractual commitments built into SIVs either through implicit expectations or reputational-risk fears.

Building on the FASB rules is a proposal from the banking agencies addressing how to handle the regulatory-capital impact of newly-consolidated positions. I draw your attention to this because how the agencies handle asset consolidation is important not only in its own right and with regard to asset securitization, but also as an early indication of what the U.S. agencies will do with the broader capital rules demanded by the G-20. Despite fervent arguments from the banking industry and ABS market participants, the proposal takes a tough, tough stand on consolidation. Burned badly by SIVs and structured ABS, the regulators want them on the books and they want risk-based capital booked against them.

It's important to consider the consolidation rules in the context of the risk-retention ones. Either way, regulatory-capital standards could undo the fundamental value of securitization: moving assets off a bank's balance sheet and freeing capital to be lent again. But, if nothing is done, markets will surely resume their over-merry ways, leading in short order to another bout with systemic risk resulting from risk-free securitization.

A Capital-at-Risk Way Out

As we think about the risk-retention and consolidation rules, it's important to start with the recognition that they won't go away. Regulators and policy-makers are so burned – not to mention so mad – by the market shenanigans that got us to this sorry point that they will not countenance any rules that smack of earlier practice. But, they are beginning to recognize that, if they go too far on either the risk-retention or consolidation requirements, asset securitization will end and, with it, market recovery will falter.

What is the "new normal?" Here, I think it will be alternative ways to ensure that private capital is at risk in ABS. Some of this might come from originators, some from issuers and some from third-party insurers or other proven providers of credit-risk mitigation. Defining these structures and ensuring they get regulatory-capital credit is a critical task immediately at hand, since without a good balance here, too much risk will return to the disadvantage of prudent securitizers or markets will simply dry up altogether.

TALF, PPIP and Whither the USG

One possible outcome of the risk-retention and consolidation rules is something that scares me a lot: a shift in securitization only to structures with significant federal control. There's been a lot of talk about an "exit strategy" for the FRB and Treasury, but most of this focuses on how the federal government can unload the trillions it's taken on without sparking massive inaction or other ghastly macroeconomic consequences. There's been a lot less talk about ensuring an exit strategy that gives private capital more of a role than simply acting as a porter bringing assets to various federal windows for whatever pittance the government will pay.

To be sure, there's a flip side of federal involvement: awesome returns that put taxpayers at far more risk than private investors. So far, that's the course the federal government has chosen with its securitization jump-starts. Although highly complex programs with lots of legal risk, TALF and PPIP are still no-lose propositions for those few investors who can manage their complexities and conditions. Think about it – Treasury matches investors dollar-for-dollar in PPIP and, for good measure, lends the funds to get the party rolling. In TALF, the Fed isn't ponying up quite so much, but it's still darn generous, providing non-recourse funding to support issuance of eligible ABS.

It's tempting to discount TALF, PPIP and a similar FDIC program from forecasts about the future of asset securitization because all of these efforts have gotten off to such a slow start. However, the billions in them have dictated terms throughout the ABS market and, in several sectors, remain the only avenue to secondary markets. Together with the GSEs and, for residential mortgages, the Federal Housing Administration (FHA) and Ginnie Mae, the USG is about all there is. The bigger they get, the higher the odds that private capital simply will not return to asset securitization – assuming the new regulations I've already discussed leave any room for them.

The GSE Get-Go

Finally, let me turn to the future of Fannie Mae and Freddie Mac – critical of course to residential-mortgage finance now and for the future of this critical business line. In past years, I expressed grave fears about Fan and Fred, based on their leverage, lack of internal controls and – worst of all – insulation from either market discipline or effective regulation. That's of course water under a very costly bridge, with both of the GSEs in conservatorship and the USG in hock to the tune of $1.2 trillion – so far – for all the backstops required to keep them going.

And, that's not counting the other housing GSE – the Federal Home Loan Banks. Little noticed, this $1 trillion-plus system has at least four members with very serious financial problems keeping their regulator, the Federal Housing Finance Agency, up nights.

The Obama Administration has promised to provide a game plan for all of the housing GSEs in the FY11 budget. Although that date might slip, Congress is already turning to the GSEs, in part because the GOP blames the GSEs for so much of the current debacle. This morning, the Senate Banking Committee held a hearing on the future of Fannie and Freddie. I expect more attention to them will slip into the already-crowded debate over industry reform, although the press of mark-ups and other action on the rest of the plan will preclude real work on the GSEs absent a crisis.

Some of your banks have already weighed in on aspects of the GSEs' future, focusing in particular on ways to ensure they stay part of the solution through extended higher loan limits and other market supports. Some institutions have also started work on grander solutions – privatizing the GSEs, creating them as co-ops, restructuring them as public utilities being among the most prominent ideas fleshed out in some detail recently by industry groups.

At this point, it's hard to assess which of these ideas or the many others in play will advance, in large part because the GSEs' conditions remains so perilous. The consolidation requirements I discussed also apply to Fannie and Freddie, bringing more assets on to the books at a time when they can least afford it. While no regulatory-capital sanctions will apply in the conservatorship, consolidation deepens the GSEs' GAAP hole and likely will force billions more from the Treasury. If Treasury can't keep the GSEs above negative net worth, current law requires a receivership that would stop whatever market recovery we've got dead in its tracks. Thus, Treasury will use all of the $400 billion pledged to Fannie and Freddie if it has to and – if even that's not enough – it will find other ways to prop the GSEs up until a restructuring can advance in orderly fashion.

What might that restructuring be? I would guess it won't be any of the radical ideas – privatization, nationalization – on the table because these ideas do too much damage to GSE investors – the FRB and Treasury top of the list, along with central banks and systemic-risk institutions around the world. There's a lot of talk of good-GSE/bad-GSE options, and I think there's a lot of promise to some of them. However, picking the GSEs apart without doing damage to GSE-obligation holders – governments included – and a very, very fragile recovery won't be at all easy.

Another significant complication in getting the GSEs going again is the fiscal-policy impact of any restructuring. I can't imagine the Obama Administration proposing or Congress endorsing any solution that deepens the already frightening hole drilled in the U.S. deficit during the financial crisis.

So, what does that leave? I suspect it's classification of the GSEs as systemic-risk institutions under the new regulatory regime. This will put the Fed's heavy hand on Fannie, Freddie and the FHLBs, forcing far higher capital, control and other requirements on any surviving entity. These requirements will substantially complicate any simple privatization or re-GSE-ization of Fannie and Freddie because the returns any private investors could get will be, to say the least, a long time coming.

This will force a new structure on the GSEs, with or without private shareholders. One option is to turn Fannie and Freddie into successors to the FHA, boosting its profit potential and getting a tidy bump in federal revenue along the way. Remember that Fannie was turned into a GSE in 1968 to make some of the Vietnam era's deficit go away – a restructuring that converts costly government assets into an off-balance sheet obligation of the USG is looking mighty tempting right now. Another option would be – with or without any change in FHA – to redefine the GSEs' function. For example, the Obama Administration has discussed making them just catastrophic-risk guarantors for private insurance and/or covered bonds.

Conclusion

Whichever of these solutions is advanced will of course have profound impact on each of your banks, and not just for residential mortgages. Some of your institutions have looked at the line-up of a few mortgage colossi and decided to phase out of this business. All fine and well, but then what to do? Commercial mortgages? Small business loans? Corporate finance? Each of these sectors is also under profound stress and each is as directly challenged by the new rules and government facilities as traditional residential mortgage finance.

As a result, I do think we're looking at a significant challenge if not to capitalism as we know it, then at least to private capital in the banking system. Which sectors can stand on their own without federal support? How much capital of what sort is required going forward? Is this just a big bank game or can super-regionals and even smaller banks play too? If so, how and with whose backstop?

On a line-of-business basis, these are critical strategic challenges that strike at the core of U.S. finance. We haven't talked all that much about them because we've all been bouncing from crisis to crisis and the government's been making up policy on the fly. The exit strategy – if there is one – from all of these policies and each of the new government enterprises is a ways off, but how we get there and what's left for private banks is perhaps the most interesting question in a sea of dramatic decisions forced upon all of us by the market melt-down.