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Book and Movie Reviews

"Too Big To Save? How to Fix the U.S. Financial System," By Robert Pozen; Wiley, 480 Pages

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By Alisa Greenstein, *Hedge Fund Law Report*

Robert Pozen, Chairman of MFS Investment Management, offers an insightful examination of the causes of the current global financial crisis in his new book "Too Big To Save? How to Fix the U.S. Financial System." Pozen's text provides a detailed framework to analyze the abundance of information about the financial crisis, to avoid repeating the mistakes of the past and to create an effective plan for fixing the financial system in the future. In part one of his book, Pozen lays blame for the collapse of the financial system on the bursting of the U.S. housing bubble. The bubble, he explains, resulted from excessive debt spread globally by mortgage securitization, which allowed lenders to easily obtain cash to make more loans. When the mortgages underlying these securities began to default and later reached record highs, even the most conservative investors in mortgage-backed securities suffered heavy losses. After describing the origins of the financial crisis, Pozen's book explains in parts two through four: (1) the government's correct and incorrect decisions in responding to this financial crisis; and (2) the actions it still must take to resolve the financial crisis and prevent its recurrence. With regard to the latter, he recommends that the least burdensome regulatory strategy would be the government's best chance of success. In particular, he suggests that Congress should focus on encouraging financial innovation and on coping with systemic risks, specifically with regard to regulating hedge funds.

Pozen's book offers significantly more than a factual recitation of events leading up to and during the credit crisis. Beyond that, it offers a comprehensive framework for analysis and concrete proposals for appropriate regulatory responses. Broadly, Pozen's aim is not – or not only – to tell the story of the crisis, but rather to analyze how the crisis can illuminate and inform the appropriate relationship between government and financial markets. Pozen describes specific regulatory innovations intended to keep pace with the speed and complexity of financial innovation. He offers, that is, the analysis sorely lacking in more journalistic accounts of the crisis. In that regard, his book is one of the few in the growing literature arising out of the crisis that should inform any serious discussion of new financial regulation. See also "Book Review: 'A Failure of Capitalism: The Crisis of '08 and the Descent into Depression,' by Richard A. Posner; Harvard University Press, 368 pages," Hedge Fund Law Report, Vol. 2, No. 22 (Jun. 3, 2009).

Part I: The Housing Slump and the Global Financial Crisis

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Part I analyzes the origins of the global financial crisis. In so doing, it examines each aspect of the mortgage securitization process in great detail. He focuses on this process because he believes it constitutes the critical link between the crash in American housing prices and the global financial crisis. In the first chapter, he explains the multiple factors that caused the crash in housing prices. These include: (1) the abnormally low interest rate between 2001 and 2006; (2) the unscrupulous sales practices of certain mortgage lenders; and (3) incentives for certain house purchasers to avoid personal responsibility. The global glut of savings and the Federal Reserve's decision to lower interest rates on short-term U.S. Treasury bonds in response to the 2001 to 2002 recession drove the steep decline in the interest rate. This low rate of interest made housing much cheaper for many Americans and created a huge demand among global investors for mortgage-backed securities with higher yields and higher risks. That demand resulted in a huge increase in the volume of high-yield, subprime loans originated by mortgage lenders and sold to Wall Street firms, which packaged and resold them as mortgage-backed securities throughout the world. Unfortunately, lenders often made these subprime loans to borrowers who could not afford the monthly payments, and who soon began to default at an alarming rate. The high defaults then contributed to a sharp decline in housing prices and an abrupt halt to the mortgage securitization process.

Based on his analysis, Pozen makes several recommendations. He proposes restrictions on mortgage lending practices, the transfer of rule-setting on mortgage practices to a new federal mortgage agency focused on consumer protection and the amendment or repeal of statutes that encourage homeowners to avoid personal responsibility on their mortgages in states like Arizona and California. As to the latter, he reasons that if homeowners default on their mortgages, the holders of those mortgages should have the ability to sue the owners for at least some of the difference between the outstanding balance on the mortgages and the proceeds from the home sale. Finally, Pozen suggests that Congress seriously consider limiting the tax interest deduction to one mortgage for each family's primary residence, repealing or limiting the interest deduction on home equity loans or mortgage refinancings, and repealing or limiting the interest deduction on mortgages used to buy vacation houses or other types of second homes.

In chapter two, Pozen outlines the role of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and explains how they contributed to the crash in housing prices and the global financial crisis. According to Pozen, these publicly chartered but privately owned institutions both possessed a fundamental flaw: the conflict between their public mission to promote low-income housing and their private objective of obtaining good shareholder returns. To meet these dual objectives, Fannie Mae and Freddie Mac greatly expanded the size of their investment portfolios and then hedged these portfolios to reduce potential losses from mortgage refinancings at lower mortgage rates. Their errors in accounting for these hedging strategies precipitated major scandals, which resulted in increased legislative scrutiny. They also became the dominant buyers of subprime loans with high yields and high risks. The rising defaults on these subprime loans contributed to their insolvency in September 2008, when the government placed them in federal conservatorship.

Although Fannie Mae and Freddie Mac once purported to stabilize mortgage markets through the purchase of mortgages and mortgage-backed securities, Pozen concludes that a single federal agency could more efficiently perform this function. Accordingly, he suggests that the government shrink, sell to the highest bidder, or combine these two institutions into one cooperative, owned by relevant groups of mortgage lenders, without any special governmental privileges.

In chapter three, Pozen describes the many abuses involved in the private process for securitizing mortgages. Many Wall Street firms created special purpose entities (SPEs), shell

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corporations technically separate from such firms under accounting rules, to finance the purchase of pools of mortgages from mortgage lenders. The SPEs then issued several tranches of mortgage backed securities with different interest rates for different risk levels. Consequently, the firms could securitize these mortgages while circumventing accounting rules mandating disclosure and capital requirements because the SPEs remained off their balance sheets. In an effort to prevent further abuses, the Financial Accounting Standards Board (FASB) adopted revised accounting rules for when a SPE may be kept off a bank's balance sheet.

Pozen proposes that the government find a new approach to mortgage securitization in the private sector in order to revive the mortgage market. Specifically, he recommends an approach that would allow banks to securitize mortgages through off-balance sheet entities, subject to two conditions. First, banks must publicly disclose all continuing and contingent obligations to these SPEs such as credit or liquidity support. Second, banks must support these obligations with an appropriate level of capital as determined by regulators – tailored to their actual projected obligations to the SPEs. If adopted, these two conditions would ensure that the actual risks the sponsoring bank retained would be recognized and supported with sufficient capital. Pozen suggests that regulators study the Danish models where every mortgage promptly transforms into a standardized security with matching cash flows.

In chapter four, Pozen reviews the extensive use of credit default swaps (CDS) by bond investors who purchased mortgage-backed securities, discusses the problems they created and offers suggestions on their regulation. After issued tranches of mortgage-backed securities, the holders of those securities often purchased CDS from highly rated insurance companies or other financial institutions to protect against potential defaults on the debt securities. Pozen acknowledges that in this manner CDS offer substantial benefits, but cautions that their utilization caused serious problems. For instance, the writers of CDS did not fully understand the range of factors impacting potential defaults of highly rated tranches of collateralized debt obligations, the key differences between CDS and traditional insurance (that the buyers did not have to hold an insurable interest), or the fact that even the most senior tranches of collateralized debt obligations heavily depended on cash flows from subprime mortgages of dubious quality. They also failed to account for the demands for cash payments by CDS holders in the event that the value of the relevant tranche of a collateralized debt obligation declined. As a result of this ignorance, AIG collapsed, further exacerbating the financial turmoil in 2008.

Pozen offers nine specific lessons for future use of derivatives based on his understanding of these mistakes. Most notably, he recommends that industry players:

1. Do not mechanically extrapolate favorable trends from the past;
2. Take special care when making projections about new products;
3. Identify the low probability events that would be disastrous for business; and
4. Understand the technology underlying derivatives before using them or approving their use.

Part II: Impact on Stock and Bond Markets

Part II of the text assesses the impact of the financial crisis on the stock markets and the availability of short-term loans. As Pozen describes it, the stock market plunged by over 38 percent in 2008. The primary causes of that decline included: (1) short-selling; (2) hedge funds; and (3) de-leveraging.

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In chapter five, Pozen addresses the misguided government attempts to limit short selling, and the need for more federal oversight of hedge funds.

Short sales involve gambling against stock, in the expectation that it will decline. In response to an explosion of short selling, in September 2008 the SEC adopted three measures. Pozen finds the SEC acted appropriately in adopting two of those measures – requiring short sellers to line up borrowed shares in advance of their sales, and to submit weekly reports on their short positions. Pozen disagrees with the SEC's temporary ban on all short selling of financial stocks. He believes this measure failed to prevent further declines in stock prices, and instead, reduced liquidity and raised trading costs for these stocks. As a result, Pozen suggests the SEC reinstate the uptick rule it had repealed in 2007. He then evaluates the SEC's two proposed approaches to the uptick rule and determines that the best proposal permits short selling once a specified price test is met. As unregulated pools of capital that can employ any investment strategy with any amount of leverage, hedge funds remain the most important and most active short sellers. As a result, Pozen recommends that the SEC develop a uniform methodology and consistent format for reporting the investment performance of hedge funds. He proposes Congress require that the largest hedge funds (e.g., those with over $25 billion in assets) submit regular confidential reports to the SEC. This regulation would, if successful, prevent the adverse effects of their failures on the financial system. With regard to these hedge fund reports, Pozen suggests they focus on the amount of leverage taken; each fund's ability to sell assets quickly at current prices; valuation methods; asset concentration; redemption requests; main trading counterparties; and risk assessment, including any concentrated long or short positions in the fund's portfolio. Pozen also suggests that, in reviewing these reports, the Federal Reserve evaluate whether any large hedge fund has become so overstretched that a small loss in its portfolio is likely to force it to get rid of a lot of assets quickly.

Pozen also supports the Treasury Department's recommendation that managers of hedge funds above a certain size ($100 million in assets under management) should register under the Investment Advisers Act of 1940. In Pozen's view, such registration would not limit their investment strategies or incentive fees but would only subject them to regular SEC inspections. Pozen cautions, however, that registration should not extend to managers of all other pools of capital, such as private equity and venture capital funds. Because private equity and venture capital funds do not trade in securities like hedge funds do, and to the extent that they invest in operating companies rather than financial institutions, he reasons that little justification exists for private equity or venture capital funds to be supervised by the SEC.

Pozen also posits that excess leverage played a key role in aggravating the financial crisis and depressing stock prices. In support, he points to a wave of de-leveraging during the fourth quarter of 2008. He explains that as the financial crisis continued, credit became scarce and collateral requirements increased. Hedge funds and other borrowers had to sell assets to raise more collateral or pay back their loans. Similarly, as financial institutions experienced heavy losses related to home mortgages, they had to sell assets to maintain leverage ratios set by regulators. As these institutions sold assets, prices declined in response to increased supply, creating further losses and triggering additional asset sales.

Chapter six critiques the SEC's decision to adopt alternative capital requirements for the five largest American investment banks: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley. He also advocates for major changes in the capital requirements for these banks. Pozen faults the SEC for allowing each of these banks to more than double its leverage ratio, the ratio of average assets to capital. To Pozen, this over-leveraging contributed to each bank's downfall. As he explains, a financial institution maintaining a high leverage ratio can greatly expand the loans it offers and securities it purchases while keeping the same amount

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of capital on hand. However, once the economy enters a recession, such a highly-leveraged institution will incur losses eroding its capital. In response, the institution must sell assets into the weak markets and incur further losses, to regain some capital.

Pozen illustrates how this occurred in the recent financial crisis. Bear Stearns accepted a merger with JP Morgan at a nominal share in March 2008. Lehman Brothers filed for bankruptcy on September 15, 2008. On the same day, Merrill Lynch agreed to merge into Bank of America. A week later, the Federal Reserve allowed Morgan Stanley and Goldman Sachs to convert from broker-dealers to bank holding companies. As a result, both companies became subject to the capital requirements of the Federal Reserve rather than the SEC. According to Pozen, this "statutory vacuum" left the SEC virtually helpless to determine any bank's overall risk levels.

To avoid future problems, Pozen recommends that Congress grant the SEC supervisory powers over all holding companies and affiliates of broker-dealers not already subject to supervision by a competent regulator. He cautions that excess leverage can lead to disastrous results. Thus, bank regulators should increase capital requirements during a strong economy so a sufficient cushion remains during recessions.

Chapter seven outlines the measures the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) in response to the financial crisis in an effort to stimulate short-term lending. And, he discusses their adverse implications for controlling inflation and monitoring financial risk. Pozen first discusses the FDIC program to guarantee most debt issued on or before October 31, 2009, through mid-2012, by depository institutions and their holding companies. Pozen describes three glaring defects with this program. First, the guarantee creates an obvious "moral hazard." Large investors who buy debt no longer have an incentive to scrutinize the financial situation of the issuing institution, since the FDIC will repay them even if the institution becomes insolvent. Second, the FDIC extended beyond protecting the special functions of banks when it guaranteed debt of both bank holding companies lacking fully operational banks and thrift holding companies engaged in industrial activities. Third, the program provides thrift holding companies unfair competitive advantages over firms that do not own a thrift. To remedy these deficiencies, Pozen propounds that the FDIC limit its guarantee to only 90 percent, and that it charge differential fees based on the financial stability of the issuing institution.

In chapter eight, Pozen argues against the expansion of federal guarantees for bank deposits from $100,000 to $250,000 per account, because that would increase the financial costs of bank insolvencies. He also warns against any federal insurance for money market fund accounts, which essentially pay interest on short-term investments. He believes that insuring money market funds would result in additional regulation, and would adversely affect their market usefulness.

Part III: Evaluating the Bailout Act of 2008

In Part III of the text, Pozen evaluates the effectiveness and limitations of the Bailout Act of 2008, the Stimulus Act of 2009, and related measures. The Bailout Act (Emergency Economic Stabilization Act of 2008) broadly authorized the Treasury Secretary to spend up to $700 billion to purchase mortgage-related assets from any financial institution headquartered in the United States. The Stimulus Act (American Recovery and Reinvestment Act of 2009) placed restrictions on executive compensation in all banks receiving federal bailout assistance.

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In chapter nine, Pozen articulates two criteria for deeming a financial institution "too big to fail" (or justifying the bailout of a bank). These include: (1) whether the financial institution remains critical to the payment process; or (2) whether the financial institution's failure could wreak havoc on the financial system by causing the insolvency of other large institutions. Pozen believes the Treasury Department should not recapitalize all large banks in a preemptive move to prevent deterioration in the financial sector; nor should it recapitalize small banks as a mere political concession. He sees these bailouts as large direct financial burdens for taxpayers to bear, and a disincentive for the market to monitor financial institutions. He recommends halting the government's infusion of capital into financial institutions that converted to banks, unless they have reached the brink of failure and fit the definition of an institution "too big to fail."

Pozen also illustrates the limitations of the Stimulus Act of 2009, which restricted compensation at any bank receiving federal assistance by limiting executive bonuses to one-third of annual compensation. That Act also allowed participating banks who had obtained bailout funds in exchange for their preferred stock to redeem that stock from the Treasury at any time without raising any new capital from public or private sources. According to Pozen, this provision was counterproductive. He pointed out that ten financial institutions redeemed $68 billion in preferred stock from the Treasury Department within seven months of issuance. These quick redemptions suggested to Pozen that the institutions were not truly failing if they were in a position to repurchase their preferred stock from the government. Pozen recommends instead that regulators insist that recapitalized banks raise capital from non-governmental sources, rather than take the circular path of using federal capital to generate earnings in order to buy back preferred stock from Treasury.

Next, in chapter 10, Pozen evaluates the Treasury's two public-private partnership programs, one to purchase legacy loans and the other to purchase legacy asset-backed securities. The legacy loan program is financed by guarantees from the FDIC, which will auction a bank's loans for sale. Pozen laments that the bank can still reject the highest bidder. Pozen also criticizes the legacy securities program, which is financed by the Fed and the Treasury, which will choose at least five investment managers to run partnerships. He says it is not clear whether these bidders or managers will be able to agree with the banks on a mutually acceptable price for the most troubled assets. Moreover, the funds that the low-interest, non-recourse loans in these two programs are too generous to private investors. Instead, Pozen recommends that the federal regulators divide each of the large troubled banks, with the government as the majority owner into a "good" and "bad" bank. The good bank could get back to business as usual and the bad bank would gradually work out the troubled assets over several years. This approach is novel in that it would avoid the problem of pricing troubled assets if the bondholders of the large bank maintained their same proportionate interest in both the good and bad banks.

Part IV: The Future of the American Financial System

In chapter thirteen, Pozen discusses the threat posed by the financial crisis for the free flow of international capital and trade. He suggests the global imbalance in capital flows constitutes one of the significant contributing factors to the current financial crisis. In addition, he warns that the recycling of global flows makes the world even more vulnerable to financial crises. Instead of behaving according to the normal laws of supply and demand, investors tend to buy more stocks as their market prices rise and fewer stocks when their market prices fall sharply. Accordingly, in order to reduce the frequency and impact of future financial crises, he recommends that banking regulators adopt anti-cyclical measures. These measures could include requiring banks and other financial institutions to build up excess capital during a strong

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economy so they have larger capital cushions when the economy declines. And, according to Pozen, the best solution may involve requiring banks to report excess reserves separately from normal reserves on their financial statements. Such a requirement would allow investors to see whether and when banks deplete their excess reserves to cover current losses. Finally, Pozen suggests that nations should not agree to adopt protectionist measures since they lead other countries to retaliate with their own parochial measures.

In chapter fourteen, Pozen concludes the book by discussing the implications of the current crisis for re-designing the American system of regulating financial institutions. Among other things, he recommends that Congress pass legislation giving one federal agency the responsibility of monitoring systemic risk. This agency should focus on four factors historically associated with financial crises: (1) inflated prices of real estate; (2) institutions with high leverage; (3) mismatches between assets and liabilities; and (4) fast growing products or institutions. He names the Federal Reserve as the logical choice for this agency, although he warns it should not become the primary regulator of all institutions posing systemic risks. He appears to be concerned, among other things, that: (1) if the Federal Reserve became the exclusive regulator of any non-bank financial firm, that action would send an implicit signal to investors that the firm is probably "too big to fail," thereby undermining the incentives of investors to monitor the activities of that firm; and (2) the Federal Reserve could not possibly have sufficient in-house expertise to be the exclusive regulator of the many different types of financial institutions. Instead, he recommends that existing regulators (e.g., the Labor Department for pension plans) continue to supervise large institutions and risky products on a daily basis. Pozen also suggests that Congress create a new federal agency focused on investor protection to make and enforce rules for mortgage origination. Notably, he also suggests that Congress merge some of the financial regulatory agencies, such as the SEC and CFTC, in order to improve coordination and response times in the event of a financial crisis. Yet, at the same time, he urges Congress to resist calls for consolidating all financial regulators into one umbrella federal agency because of the huge transition costs that would entail.

Indeed, despite the delegation of power to federal regulators that he recommends, Pozen recognizes definite limits to the effectiveness of any federal regulator in light of the fast pace of financial innovation and complexity of financial transactions. He suggests creating a board of "super directors" to monitor the financial condition of a "mega bank" and to set the compensation of its senior executives in order to attain the dual goals of maximizing long term profits for its shareholders without taking risks that would materially jeopardize the bank's solvency. Pozen suggests these "super directors" may be critical to fixing the financial system and moving it to accountable capitalism.

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