

ARE THINGS BACK TO NORMAL?

Some Observations
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Some Normality

- First, there are a few signs of normality:
- The Red Sox again are contending for the American League playoffs.
- Already, tickets are being sold for BU-BC hockey games next winter.
- 2009 compensation at some Manhattan financial companies will return to 2007 levels.
- Investment bankers are designing new financial structures and creating markets, eg: California IOUs, c/s/v for life policies.

Stability Restored At The Systemic Level

- Second, for now the financial system has stabilized and returned to functionality, but not without massive financial underpinning from the governments' treasuries.
- The Federal Deposit Insurance Corporation and US Treasury have reported the US Government offered financial institutions support facilities totalling \$13.9tn at Mar-31-09.

Bank Problems Persist

- Third, we have learned from past financial crises that normality does not return until we solve the problems in the banks.
- This spring, the US government conducted "stress tests" of the largest 19 US banking companies representing some 87% of all US banking assets. The tests call for some \$75bn in new common tangible equity capital in those companies. (The International Monetary Fund has put that figure at \$275bn)
- The stress tests indicate strong gross earnings at the 19 companies, but those earnings will need to be put away in reserves to cover estimated future losses \$600bn. Many analysts believe potential losses are much higher.

Bank Problems Persist

- The stress tests themselves are not new. They have been conducted during past crises. What is not normal, is that the stress tests were led by the US Treasury and the results a matter of public disclosure.
- The stress tests do appear to have revived the Federal bank examination process at the largest banks. 150 Federal bank examiners conducted the tests, taking their own assessments of the banks' conditions rather than relying solely on the views of the bankers.

Bank Problems Persist

- Fourth, the crisis in finance sent shocks onto the real economy. Now the real economy is sending shocks back into the financial system.
- Again, We can expect very good gross bank earnings, but at many banks those earnings will have to be captured in reserves for building loan losses.
- We can expect the FDIC's list of 416 problem banks to get longer.
- We can expect the number of failing banks to continue to escalate above the 77 failures so far this year.
- Simply, we see increasingly delinquent loans across the spectrum of consumer credit and property loans.

Real Estate Still Looms Large

- Fifth, the US cannot return to normalcy until we return to some sort of normal conditions in residential finance. But there seems to be no end in sight to the difficulties in home finance.
- Home values have dropped some 30% or more from their peak value \$22tn in 2006. Then, real estate mortgages totalled \$11tn, including \$1tn in subprime loans. Home equity loans were an additional \$800bn at that time.
- Now, 9% of all residential mortgage loans are delinquent. 13% of mortgage loans are either delinquent or in foreclosure. And, these problems occur among both subprime and prime loans.

Stressed Household Finances

- Sixth, household finances are under great stress.
- US Household debts are \$13.9tn, about 130% of household incomes.
- US Household net worths have dropped some \$13tn because of declines in the values in homes and securities accounts, especially retirement accounts.
- Household incomes are flat if they exist at all. The US unemployment rate has soared from 4.8% to 9.5%, a loss of some 6million jobs. 48 states have unemployment rates, ranging from 8% to 14%. The average hours worked is at 33 per week, the lowest since 1969.
- Households who can save are doing so sharply, and they have reduced their borrowings by \$100bn. Additional consumer borrowing is difficult because of stretched household finances, foreign lenders have disappeared, and domestic lenders have tightened their underwriting standards and raised their prices.
- As the BIS states: "Household consumption is likely to be constrained for some time."
- A Federal Reserve survey shows no normalization of underwriting standards for households until 2011.

Stimulus Not Yet

- Seventh, the US economy is in deep recession, perhaps -5%.
- Much of the \$787bn stimulus package is scheduled for disbursement during the Congressional election year 2010.
- So little stimulus underway, now
- Except for the additional \$1tn in investment activity by the Federal Reserve ,which further pulls the Fed into the political process.

Fiscal Constraints

- Eighth, the Federal fiscal finances are ugly. US Government Debt stands at \$11tn, which rises to \$12tn in 2010, \$13tn in 2011, and some additional \$4-7tn out to 2019.

Troubled Municipal Finance

- Ninth, spending by the 50 state governments is significant to the US economy.
- However, 42 states have budget gaps totalling \$123bn for 2010 and \$230bn out to 2011.
- States' income tax receipts are running 26% below normal.
- So, dramatic cuts in spending and services are occurring in state and municipal governments across the country.

Potomac Policing, Policymaking

- Tenth, Congress has become extraordinarily involved with the financial and economic crisis. It has no choice, given the scale of problems across the household and government finance sectors, as well as the degree of taxpayer assistance to bail out financial institutions.
- Continuously, the Congress conducts hearings, oversight, and investigations.
- For sure, Washington has become the financial center of the US, as the Government expands its debt to substitute for the deleveraging underway by households and financial institutions.

Need Faith

- Normality cannot occur until trust is restored in financial institutions and financial regulators.
- Restoring confidence takes time.
- Trust will not return until the public believes financial markets are being adequately regulated and supervised.

New Arrangements For New Realities

- Rescue, Repair, Reform, Reorder
- Rescue: Massive “whatever it takes” taxpayer guarantees, loans, investments
- Repair: cleanse balance sheets, strengthen them, and insert “fit and proper” governance
- Reform: comprehensive regulation
- Reorder: Global cooperation/coordination

New Arrangements For New Realities

- Comprehensive oversight
- 21st century tools
- Stronger prudential supervision of risk
- Countercyclical policies
- Consumer protection
- Global compatability and consistency

New Arrangements For New Realities

- Macroprudential powers for central banks
- US Financial Services Oversight Council
- Countercyclical standards to dampen, not amplify, economic cyclicity
- Stronger regulation-oversight of markets
- US Consumer Financial Protection Agency
- Special bankruptcy laws for large, complex financial companies

New Arrangements For New Realities

- Enlarged role for the International Monetary Fund, Bank For International Settlements, Financial Stability Forum, et al
- Enlarged roles for China, India, Russia, et al, eg: G-20 vs G-7

Lastly But Firstly

- Policymakers need to determine what we want the financial system to do?
- Then, establish the regulatory regime to accomplish that objective.