

How Do We Get Out of Here?

(Regulatory Chaos + Banking Rules + Tax Policy = Banking Hysteria)

What we have today is a problem in the financial sector of the world economy. It began in the US, and it has expanded globally. In my view, it is the result of many well-intended rules, some mistakes, some bad decisions, some malfeasance and a bit of Murphy's Law. What follows is how I saw this unfolding during the past 30 years. I don't pretend that it's exhaustive. It's just what I've seen and how I've seen it.

I have been involved in mortgage finance off and on since 1977. At that time, I was working as a property manager on a defaulted loan workout team for a Chase Manhattan Bank REIT. That was when the Community Reinvestment Act was introduced. As I understood it, the Act was passed to make it easier for low-income citizens to buy homes. It did so by mandating that a certain percentage of homes in communities be "affordable housing." More than 30 years later, I still don't know anyone who can tell me exactly what "affordable housing" really means.

The act was confirmed by a Supreme Court decision called the "Mount Laurel" decision, so called because it involved housing in Mount Laurel, New Jersey. It served to restrict the number of homes in communities and increase prices in growing areas (those houses which were not "Mount Laurel" houses tended to cost more).

During the 1980's I saw a shift in lending patterns around the country. Securitization exploded. Local lenders made loans and sold mortgages that were subsequently pooled and purchased in capital markets. The national scope of this process eliminated the concentrations that made local lending riskier. In turn, this made it more attractive for lenders to make loans locally and invest (even at a lower interest rate) in the larger pools. That happened both in residential and in commercial mortgage lending.

Initially, the buyers of the mortgage-backed securities were the lenders who had underwritten the loans – and most of them were still servicing the loans. These folks did not report much more than the bare minimum about their loans. For one thing, they didn't want to disclose too much to their competitors.

Another factor in this lack of transparency was that it was costly to prepare elaborate reports. Since the whole idea behind securitization on a national scale was to reduce risk by reducing concentrations in single local markets, the fact of securitization itself was expected to provide a level of confidence that would have otherwise required extensive ongoing disclosure.

In 1986 Bill Bradley was given the task of drafting the legislation in a simplification of the income tax code negotiated between Congress and the Reagan administration. I was happy with the stated intent: to simplify the tax code with fewer brackets and a lower top rate. The trade-off came from Senator Bradley's desire to eliminate loopholes. The unintended consequences of those were little short of catastrophic.

The first problem came when the act eliminated passive losses as deductions. That had a detrimental impact on the commercial real estate market. If you're like me, you'll want to know why those have anything to do with one another. I'm glad you asked.

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In the 1980's, a large percentage of mid-range (\$1-20M) commercial real estate in the United States was owned by professionals (dentists, doctors, lawyers and the like). They typically purchased a property such that the rents were about equal to the expenses (including debt service). They depreciated the building, taking the "paper loss" on the building as a deduction against their income as professionals. When they disposed of the building (at about what they paid for it), they realized a profit. That gain was taxable as a long-term capital gain and could be spread out over a number of years. This often led to significantly higher prices for many buildings than would have been the case otherwise.

I knew several professionals at the time who used this strategy (full disclosure – I was invested in a couple of limited partnerships doing this very thing). With the elimination of passive deductions, they could not deduct losses incurred in another business (real estate) against their primary income.

As a result, commercial property values plummeted, often by 40% or more; residential values followed. When a 40% value decline happened, a perfectly safe loan at 75% LTV (Loan-To-Value, one of the most important ratios in the mortgage industry; the lower the LTV, the safer the loan) became an extraordinarily risky loan at 125% LTV. Both direct loans and securitized loans had much higher default rates.

Lenders who had invested in these were suddenly "imprudent," and a scandal ensued. I knew doctors and lawyers who walked away from their properties because they were no longer worth keeping. I also knew a couple of bankers whose institutions were taken over by the Resolution Trust Corporation (RTC – more about this shortly) and merged with other banks. All because a tax law was changed and its consequences had not been considered.

As I understood it, another part of this reform eliminated (or greatly limited) the option for a bank to use a write-down of a loan's value as a deduction against a current period's income; it was only deductible if the loan was written off. This compounded the above problem: the same thrift institutions could not take a tax write-off against the loans which were no longer worth as much; they could only foreclose and take a loss when they sold the property. Whether that was part of the 1986 Tax Reform Act or a change made at another time, it is now the law. This situation is still haunting us today, compounding mark-to-market distortions in the news today.

The Resolution Trust Corporation (RTC) took over the assets and operations of failed banks (mostly savings and loans) in the wake of the bank failures of the late 1980's and early 1990's. They created the initial Commercial Mortgage-Backed Securities (CMBS) and sold them in the capital markets. The RTC recovered most (over 85% after expenses) of the taxpayer money invested in the savings and loan (S&L) "bailout" of 1990, but banks themselves were gone. Personally, the impact of the Tax Reform Act and the RTC cost me a little over a million dollars – my entire net worth at the time.

The cash flows from traditional mortgage-backed securities were very "lumpy." They could be very erratic in the timing of the payments. For certain investors, getting their capital too soon could be almost as bad as getting it too late. To smooth out the cash flows for investors (making them appeal to a broader base, Freddie Mac introduced the Collateralized Mortgage Obligation

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(CMO), which consisted of many small “slices” of the cash flows that could be purchased by investors with more granular timing needs.

Historically, FHA and VA made subsidized home mortgage loans to qualified low-income borrowers. In the 1980’s they began selling them to GNMA, who in turn packaged them and sold them to the capital markets as securitized bonds. That was the traditional way of funding mortgages among low-income citizens. My parents got their first mortgage as an FHA loan.

In 1992, the Federal Reserve Bank of Boston published a paper on discrimination in the housing finance marketplace. In the paper, the Fed claimed that traditional mortgage underwriting was inherently discriminatory. They cited studies alleging that minorities of a given income were rejected when applying for credit far more often than whites of the same income, even when their credit scores were equal to (or in some cases lower than) those white borrowers. The paper also found that low-income borrowers often paid higher interest rates than the statistical risk of default on loans would justify.

This paper concluded that because traditional mortgage lending standards and practices were inherently discriminatory, lenders should be prevented from (or restricted in) using those guidelines in the future. Although the underlying research was soundly debunked within 18 months (borrowers of equal credit scores tended to get the same approval rate regardless of ethnicity and they tended to pay the same interest rates), the paper accomplished its intended result: federal bank regulators began imposing strict minority lending standards on banks and lenders of all kinds. The result of these standards was that credit policies for most lenders were relaxed – across the board.

In 1993 (partly in response to this paper and the uproar over its conclusions) President Clinton issued executive orders creating a much broader scope for enforcement of the Community Reinvestment Act (CRA) and the Equal Housing Opportunity Act (EHOA). The intent seemed laudable: to broaden the scope of housing for the poor by encouraging or requiring more aggressive mortgage lending. The results were more ambiguous: these mandates resulted in roughly \$1 trillion in loans to low-income areas during the 1990’s. Defaults to these institutions increased, but linking defaults directly to CRA lending is difficult for many reasons, some of them political (banks are discouraged from tracking those loans as a separate category). That had a similar impact: traditional credit standards were loosened across the board.

One result of these changes was that banks made more loans to lend to high-risk borrowers under CRA guidelines or EHOA. Traditionally, FHA loans had been available to the most credit-worthy of low-income borrowers. Those loans were now made without the federal guarantee inherent in the FHA loan.

Because of the increased availability of bank credit, fewer low-income borrowers applied to the FHA or to high-risk lenders (like Champion Mortgage or The Money Store) for mortgage loans. Those lenders began making even riskier loans (the beginning of “sub-prime” lending). In other words, high-risk lenders were driven to make increasingly risky loans in order to profitably deploy capital.

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The use of that process accelerated during the Bush administration. Although President Bush relaxed some of the Clinton mandates, many of the effected lenders continued to make “risky” loans. After all, they had been making those loans for several years now without seeing any immediate negative consequences. As a result, they were no longer apprehensive about reaching and exceeding risk guidelines that had previously been considered unacceptable.

This regulatory imperative for lenders to make more mortgage loans to low-income borrowers extended the percentage of low-income loans (normally 3-5% of the loans made in a given year) to as much as 20% of home loans being made annually. The GSEs (Fannie Mae, Freddie Mac and Ginnie Mae) were previously limited to top-quality or federally insured loans. Since the 1990’s, their activities have been extended into the higher-risk mortgage market. Once legally forbidden (due to excessive risk), by 2007 sub-prime loans had become a significant part of Fannie Mae’s portfolio.

Lending was extended into low-income communities in a variety of ways. Some lenders implemented looser underwriting standards for certain loans (those to low-income or minority borrowers). These looser standards included limited or no documentation, limited or no down payment and less rigorous enforcement of timely payments. There were also rules which required lenders to approve loans unconditionally if the borrower qualified for teaser rates without regard to their ability to make post-teaser monthly payments. All these aggressive lending tactics were actively encouraged by the various banking regulatory authorities (OTS, OCC, The Fed, FDIC, FSLIC, SIPC, FHA, HUD, SEC and all 50 state regulators – if I missed any, please forgive the omission). Since discrimination was the thing being opposed, it was illegal to limit the aggressive lending practices only to minority borrowers.

In 1999 the Gramm-Leach-Bliley Act repealed the Glass-Steagall Act of the Depression Era, which prohibited investment banks from participating in commercial banking and prohibited commercial banks from becoming active in investment banking. There were also a number of changes involving ways banks could interact with insurance companies.

There were several positive results of Gramm-Leach-Bliley. Investment banks could now participate in direct lending to homeowners and businesses, leading to more money and growth for the entire economy. Commercial banks could now approach the capital markets directly to buy and sell assets and liabilities. This lowered the cost of money to borrowers on Main Street.

On the negative side, loans made by investment banks sometimes lacked the underwriting scrutiny given to loans made by institutions who planned to hold them to maturity. This led to a lot more poor-quality loans than normal, compounding the trend begun in the 1990s under the expanded scope of CRA and EHOA.

Some commercial banks became overly aggressive in their capital market activities, leading to higher exposure to risk than they would normally incur. Part of that was the classic mistake of borrower short and investing long (putting short-term money into assets with long-term payoffs). The logic was that since it will be sold to the capital markets, it’s ultimately somebody else’s problem. These loans (and the bonds they supported) also lacked granular reporting, but they were no longer being purchased by lenders who were effectively buying one another’s debt.

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The Sarbanes-Oxley Act of 2002 (SOX) was passed in reaction to the scandals of Enron and WorldCom. The intent was to provide greater disclosure to the investing public about corporate activity. It also established very granular controls over how public companies had to account for options used as incentives for key employees. The end result of the act was a great deal more mandatory (and expensive) accounting activity for public corporations.

The effect of this has been to virtually kill the Initial Public Offering (IPO) market in the United States. Critics say that the average cost for a new company to comply with SOX is about \$4M per year. They also say that this has been done without materially increasing the insights provided for investors. Proponents of the bill say that it has prevented more scandals. Dogs also say that howling at a full moon prevents the moon from falling on them.

From 2002, the Federal Reserve kept interest rates artificially low (below the rate of inflation) to prevent recession. This had an indirect impact on mortgage rates, but it had a direct impact on the money supply, which in turn gave high-risk investors cheap money to use for leveraging their investments. These factors led to a public perception of almost “free” money.

By 2005, borrowers were looking for the free money that “everybody” knew about, and lenders were all too willing to give it to them. That meant that the dollar volume of the inevitable bursting of the bubble got a lot bigger before it began to look shaky.

By 2005, all these trends and rulings had begun to feed on one another. Some rulings limited lenders’ ability to limit high-risk loans to the truly needy, opening the door to speculative borrowing. This led to an explosion of high-risk loans all around. This in turn led to recklessness that filtered through the industry:

- Brokers were encouraged to write sub-prime loans, so some of them deceived borrowers and actively encouraged borrowers to commit fraud.
- Lenders came up with ever more creative programs that enticed people to borrow money regardless of whether they could really pay it back.
- Capital markets devised many secondary (derivative) instruments such as Collateralized Debt Obligations and their offshoots (CDO, CDO², etc.) to re-package bundles of mortgage loans that were too risky to sell directly.
- Credit Default Swaps (CDS) were issued extensively, often by companies that did not truly have the resources to honor them in the event of a real default. These made risky structured bonds appear safer than they actually were. They also created huge risks for the brokers whose clients wrote these CDS instruments, because if the client defaulted, the broker had the entire liability to make good on the guarantees of the CDS.
- Many people borrowed with reckless abandon, confident that rising home prices would give them more equity and cover their imprudence. This was not limited to low-income borrowers, but included millions of speculators.

In 2005, the Federal Reserve began to increase short-term rates in order to cool off the credit markets. Because of the intermediate step of securitization, that process had about a one-year lag time in its impact on mortgage markets. For that reason (among others), mortgage prices were

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no longer in sync with short-term interest rates. That made the models used by the Federal Reserve inappropriate to that situation. Instead of using common sense, the Fed kept saying that their models show that something different was happening – and they stopped cutting rates at the first sign of political pressure.

In 2005 the Securities and Exchange Commission (the SEC is the federal regulator in charge of regulating the stock exchanges, bond exchanges and the financial investment markets) weakened the rules against “naked short-selling.” Previously, if an investor wanted to sell a stock he didn’t own (which is what short selling means), he had to borrow the shares from someone who owned them before he could make the sale. That limited the ability of speculators to drive down the price of a company’s stock, because people who owned shares would not be inclined to permit extensive short-selling, which would reduce the value of their holdings. With this rule no longer in play, it became easier to manipulate the price of shares in troubled companies.

Around the same time, the SEC suspended the “uptick rule,” which was another restriction on short selling. This rule only allowed short sales after the price of the stock went up. Relaxing this rule also made it easier to manipulate the price of shares in troubled companies.

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In 2006, the SEC began pushing for “Fair Value Accounting,” a process widely used in Europe. The concept seems logical, but it is based on the false presumption that all financial assets are equally liquid (saleable) and equally free of distress or other pressures that would distort value.

Responding to that pressure, FASB (the Financial Accounting Standards Board) issued Rule 157 in November 2007. Combining the increased disclosure sought by Sarbanes-Oxley with the expanded reach of institutions effected by Gramm-Leach-Bliley, FASB 157 requires marketable securities to be marked to market price regularly. This is often daily, but at least monthly.

For assets held as for immediate trade, this is reasonable. For assets purchased to be held to maturity, some say that FASB 157 is tantamount to a suicide pact imposed on financial institutions by regulatory fiat. Its defenders claim that it provides unparalleled transparency. Its critics say that it is more like a fun-house mirror than a pane of glass, distorting values upward in a bull market and downward in a bear market.

When banks are required to mark down assets, they are then required to re-structure their capital to maintain the mandatory level of regulatory capital. The mark-down causes a significant loss, but banks cannot use that loss against their tax revenues. This creates a disincentive for banks to accurately reflect their write-downs, because of the tremendous cost and perverse requirement to pay income tax on the loss (see above). When write-downs do happen, they have an inordinate negative impact on a bank’s balance sheet. Today, that hysteria has become a multi-trillion-dollar federal investment. That may be fine, but without fixing the regulatory chaos that underlies it, we just magnify the scale of the problem without preventing its recurrence.

FASB 157 does more than just impact banks. Insurance companies holding assets needed to meet policy or pension obligations in the future are also required to mark down their assets to a

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current “market” price (as defined by a speculative index). The fact that they have no intention of participating in the current market is deemed irrelevant to FASB 157. That can lead to a need to re-structure their portfolio and dispose of assets in order to avoid scrutiny from state Attorneys General enforcing state laws governing asset sufficiency for fiduciaries.

Brian Westbury of First Trust Advisors created a wonderful analogy for mark-to-market accounting and how it works. In his example, you are a homeowner with a home you bought for \$300,000 about 8 years ago. Your mortgage was originally \$240,000 and it is now about \$200,000. In the current down real estate market, your house is worth about \$320,000. One of your neighbors loses his job and goes through a nasty divorce. Part of the divorce settlement is that he sells his house to his ex-wife for the balance of the mortgage, which is about \$150,000 (they have been aggressively paying down the mortgage instead of saving). The day after this sale closes, your bank comes to you and says that the value of your house is now \$150,000 because they have to mark it to the current housing market (the fact that you are paying your mortgage as agreed and have no intention of selling is irrelevant). In order to satisfy the Loan-To-Value covenant in your mortgage, you have to pay down your mortgage to a balance of \$120,000 (80% of \$150,000) or they will have to foreclose. That is what mark-to-market feels like to a banker today.

In reality, it is even worse than Dr. Westbury suggests. Mortgage-Backed Securities, Collateralized Debt Obligations and similar instruments are seldom traded. In order to have a market price to use, many institutions have been required to use some index (that is intended to be a proxy for the actual instruments) for the market price. This is like having a bookmaker who is taking bets on homes in your neighborhood. When the neighbor’s house sells for a low price, someone in the bookmaker’s pool bets that prices will go even lower. If the pool settles on a “price” of \$75,000 for your house, the banker can show up the next day and demand that you pay your mortgage down to \$60,000 (80% of \$75,000) to satisfy the LTV covenant. The end result? You have been compelled to give the bank \$140,000 of reserve money against a \$200,000 mortgage or be in default. No wonder bankers are singing the blues.

Now let’s look at what happened since the beginning of 2008. We had a wave of home mortgage foreclosures. Most of these were people who had no business being in the homes they “owned.” Many of them were speculators hoping to “flip” properties.

Early in the year, Bear Stearns was in danger of collapse. The Treasury offered loan guarantees for JP Morgan to buy Bear Stearns. The stock, which had been trading above \$80 per share in the recent past (and stood at about \$30 per share earlier in the week), was initially sold at \$2 per share; this price created a wave of protest among public holders of those shares. It was raised to \$10 per share (over the objections of critics who said that the public should not offer loan guarantees to the investment banks whose imprudent behavior precipitated the crisis in the capital markets), which JP Morgan still considered to be a good price.

There was an outrage in the popular press over “unregulated Wall Street excesses.” Despite the fact that there has been no evidence of such excesses, it has become an accepted “fact” that Wall Street was responsible for the credit crisis.

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In September, Lehman Brothers filed for bankruptcy. This time, the Treasury also offered to help. A deal similar to the Bear Stearns sale was reached with another buyer. While the contracts were being printed, the Treasury Secretary decided to let Lehman become a high-profile failure. What is not widely known is that both Bear Stearns and Lehman were victims of Credit Default Swaps written by clients who were unable to honor them, leaving the investment banks with the entire liability under the “counterparty risk” rule enforced by the SEC. Contrary to the notion that there were no regulations, the regulation simply passed the responsibility on to a private company without offering guidance about prudent capital requirements. In order to meet the liabilities, Bear and Lehman borrowed as much as they could, then tried to issue stock. Unfortunately for them, their stock prices had been manipulated mercilessly (by speculators relying on the relaxed uptick and naked short-selling rules). This made the investment banks unable to raise needed capital to issue stock in order to meet their liabilities.

Two high-profile investment banks failing in the same year had two very different resolution strategies put in place by the US government. These mixed signals sparked a violent downturn in the credit markets. To a certain extent, that turmoil is still in play today; credit markets have continued to contract, because fewer people are willing to lend money. They don’t know if they will have a reasonable expectation of being paid – yet the government is still setting a market interest rate at very low levels through the Federal Funds Rate (set by the Federal Reserve).

As the year wore on, a second class of mortgage defaults began to appear. These have been called the “reset defaults,” because they resulted from people who were in a variable-rate mortgage. They could afford the payments initially, but when the rates reset, they could no longer afford the payments.

In July of 2008, the National Bureau of Economic Research (the NBER is the body officially responsible for defining when we are or are not in a recession) retroactively changed the rules by which a recession was defined. They decided that we had been in recession since December of 2007. This probably coincided with the publication of a study which found that since 2003, most of the “growth” in the economy had been created by people pulling equity from their homes and spending it – absent such spending, the economy had been flat for 5 years.

Congress passed the EESA legislation (Emergency Economic Stabilization Act) in early October. Initially sold as a way to stabilize banks by purchasing toxic mortgage-backed assets, Treasury decided instead to purchase stock in the banks who owned those assets. This sent another wave of uncertainty through the financial markets – we cannot even know what the US government is going to do when they tell us ahead of time.

The stock purchase plan created the wave of “bailout mania” that still plagues us today. Instead of purchasing the assets and letting the market determine which institutions would emerge successful, our government chose to bypass the market and ensure that all the companies would remain intact, whether they deserved it or not.

The bulk of the initial bill was used to prop up shaky companies rather than fix the system. In my view, that was unsupportable. What’s worse is the fact that it was sold to the public as a

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necessary action to stave off imminent financial collapse. Nobody even stopped to ask for the supporting facts to prove that.

AIG was another company that received a large dose of federal investment. The company was only in trouble because Eliot Spitzer (the New York attorney general) had intimidated the AIG board of directors into firing the company's founder, Hank Greenberg. That had left the company in the hands of people who were incapable of running it profitably. When they began losing money hand over fist, they ran to the federal government for help from the EESA fund. Their incompetence has become clear in that each bailout has led to another (they are now on round 4). That is what we get when we let bureaucrats decide who succeeds in the market.

In early 2009 we see the third wave of mortgage defaults. These are people who have been hit by the contracting economy. Whether from lost jobs, from lower wages or from other factors, the mortgage market is now being pounded by the economy. Ironically, it was the mortgage market that precipitated the economic chaos that is now circling back to hit the mortgage market once again.

The actual asset purchase plan was pushed into the new year with the new administration. It has just been announced. Whether it succeeds remains to be seen. The real key is that we need to get rid of the government-induced uncertainty. Uncertainty is more poisonous than anything to markets, because it prevents the market from reaching a stable equilibrium.

Where Do We Go From Here?

The easiest solution is fixing FASB 157. We don't need to scrap it, but we should address its distortions to make it better. The idea of marking to market is probably a sound concept, but it needs to be tempered with common sense. We need to recognize that long-term assets need not be subject to the same volatile valuation criteria as short-term assets, especially if there is no liquid market and the holder has no desire to sell. One good way to do this is to create two different categories of debt securities. We can mark the short-term category to market hourly if need be. We can treat the long-term category as a fundamentally different class of investment; the institution should simply demonstrate quantitative justification for their assessment of likelihood of payment, likelihood of default and magnitude of default. It appears that this is being done in Washington – six months and trillions of dollars after it should have been done.

The next thing to fix is Gramm-Leach-Bliley. Realizing that not all innovations are good, we can mitigate the complete elimination of barriers between investment banking and commercial banking. We should probably still allow investment banks to do some commercial banking and vice versa. On the other hand, banking authorities can and should limit the exposure to risk that is imposed on depositors by their bankers. While that would appear to give investment bankers an advantage, that "advantage" is counterbalanced by their reliance on using only their own money or that of high-risk investors who can afford to lose their entire investments. Given recent developments, it may be that investment banks will disappear anyway, permitting hedge funds to slide into that role in our financial system.

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While we are fixing banks, we need to recognize that if marking to market has a material impact on financial operations of a firm (especially a bank), the firm should be able to treat that write-down as a tax deduction. If any write-downs result in subsequent gains on asset disposition, they should be subject to ordinary income tax plus a slight surcharge to discourage chicanery.

Although it will be politically toxic, the next thing we will need to do is hold borrowers accountable for their imprudent actions. We need to differentiate between those who can never pay and those who can pay for their homes under normal market conditions. We need to get the former out of their houses as quickly and as painlessly as possible, and we need to put in place a vehicle for re-structuring the loans of the latter – if it can be demonstrated that their initial loan is fundamentally flawed or at odds with reasonable market conditions. If common sense does not tell us to re-structure the loan on its own merits, we should let the borrower find another place to live.

Once the regulatory infrastructure is adjusted to address market reality, then and only then should we consider having the government purchase or insure (or both) mortgages or mortgage-backed securities. This should only be on a limited basis, and with a defined exit strategy. If the original lenders are required to participate in any losses, they should also be permitted to participate in any windfalls.

We need to be very cautious about extensive Treasury participation in capital markets. We do not need to make the Treasury the pinnacle of an investment banker's career path. That is because the Treasury is responsible for the economy, not just the "portfolio" of the Treasury. The Treasury already has enough authority to participate in capital markets. Let's see that authority exhausted before we consider providing even more.