Problem Statement: Current capital requirements for financial institutions holding risky mortgage securities are too low and not uniform across financial institutions. This will increase the likelihood of future insolvencies and create future systemic risks for the banking industry.

Excellent!!
MEMORANDUM FOR CHIEF OF STAFF, RAHM EMMANUEL

FROM: Christopher Jones
Special Assistant to the President

SUBJECT: Key Facts on Home Mortgage Market and Capital Requirements for Financial Institutions

As you know, the current financial crisis was spurred in large part by a collapse in the mortgage-backed security market and the declining value of mortgage-backed assets. Despite a decrease in home prices and historically low interest rates, tight lending restrictions by commercial banks and low consumer confidence have had a negative impact on the housing market.

Recently released statistics show further decline in the housing market:

- Movement of 26,000 workers from the construction industry and 61,900 from specialty contractor industry between November and December 2008 (Bureau of Labor Statistics)
- New home sales down 44.8% in December 2008 compared to previous year (Department of Commerce)
- Housing Market Index (HMI) down to a historically low 8, revealing fewer perspective buyers and homebuilders’ dismal outlook (NAHB/Wells Fargo)

One purpose of the Emergency Economic Stabilization Act of 2008 was to restore liquidity in the financial market, making credit more available to consumers, including mortgages. The

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1 Ratings below 50 indicate that more negative responses were received than positive responses.
Congressional Budget Office’s first semi-annual report on the Troubled Assets Relief Program revealed that the first purchases made with TARP cost the government an additional $64 billion with respect to the difference between the purchase price and the actual value of these assets. In addition, the Government Accountability Office found deficiencies in the oversight of the program (GAO-09-161). Current spending by TARP is troubling—limited accountability and oversight adds to the risk of making additional capital purchases from private financial institutions.

In addition, the Housing and Economic Recovery Act of 2008 revised legislation for the mortgage market. The regulatory provisions included:

- establishment of the Federal Housing Finance Agency
- giving regulatory authority of Fannie Mae and Freddie Mac to FHSA
- authorization for the Treasury Secretary to purchase troubled assets from Fannie Mae and Freddie Mac

Preceding the crisis, Fannie Mae and Freddie Mac (Government Sponsored Enterprises, or GSEs) were two primary holders of mortgages and mortgage-backed securities. Fannie Mae’s monthly summary for September 2008 shows its mortgage assets at an excess of $750 billion.

Despite efforts to mitigate the mortgage crisis, current legislation has failed to address the dominance of GSEs in the mortgage market, as well as the portfolio risks to mortgage holding financial institutions who leverage with such securities.

The Treasury Department’s Financial Stability Plan will include oversight measures to increase transparency and liquidity in the mortgage market. Although the plan will require stress tests—measuring a bank’s ability to hold risky mortgage securities for banks with assets valued over $100 billion, there is no proposed regulation that raises capital requirements for banks of all sizes³.

Financial institutions must hold a certain ratio of capital with respect to their security holdings. Riskier securities require

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² For the CBO report on TARP purchases, link to: http://www.cbo.gov/ftpdocs/99xx/doc9961/01-16-TARP.pdf

³ For a fact sheet on the Treasury Department’s plan, link to: http://www.financialstability.gov/docs/fact-sheet.pdf
higher capital requirements. Capital requirements, however, are not standard for all banks. The subprime mortgage crisis has resulted in the insolvency of many banks that had insufficient capital with respect to their risk-weighted assets. These insolvencies have further constricted credit flow and contributed to the magnitude of the current recession.4

The Basel Accord was an international agreement on banking standards, including capital requirements for financial institutions. Basel II is a revised set of these standards and will add additional capital requirements and alternate formulations for risk assessment. Several studies of the Basel II standards raise concerns over its procyclicality (amplifying the effects of booms and busts) and its inability to raise adequate capital requirements under certain conditions.5

Sheila Bair, Chairman of the FDIC, outlined the risks of the Basel II capital requirements in a 2007 testimony. The four risks of Basel II that were identified are:6

- Banks being able to set capital requirements that are too low
- Inability to tie capital requirements to risk because risk is highly subjective
- Failure of Basel II’s advanced approaches to identify capital requirements based on historical data
- Limitations caused by inability to identify changes in market practices, causing bank supervisors to miss signs of increased risk that would otherwise cause higher capital requirements

To prevent further failures in the mortgage market and prevent systemic risk to the banking industry, it will be necessary to thoroughly review policy options regarding capital requirements. For more information, please see my accompanying memo on a

4 This paragraph cites information from Calem and Lacour-Little’s (2002) article “Risk-Based Capital Requirements for Mortgage Loans,” which can be found in the Journal of Banking and Finance, Volume 28.


research strategy for locating information on capital requirements and banking regulations.
The White House
Washington
February 15, 2009

MEMORANDUM FOR CHIEF OF STAFF, RAHM EMANUEL

FROM: Christopher Jones
Special Assistant to the President

SUBJECT: Research Strategy for Factual Information on Capital Requirements and the Banking Industry

To aid our policy team, I have included this memo on my research strategy for capital requirements and the banking industry.

The first step in my research strategy was to read Wikipedia entries related to the subprime mortgage crisis. This led to the gathering of additional search terms that were queried using the Google search tool. Also, I visited websites of relevant government agencies and queried for documents related to the research. When scholarly articles were cited, I used Google Scholar to find the full-text articles. The following were the search terms I used:


Useful Sources:

- Wikipedia’s entry for the subprime mortgage crisis provided a useful starting point for my research. Specifically, the entry titled “government policies and subprime mortgage crisis” cited primary sources (scholarly articles and government documents) that I was able to find on Google Scholar.
Google Scholar provided me with several journal articles on the subprime mortgage crisis and the Basel Accord. Though the articles are dense with subject-specific terminology and theory, they provide useful empirical research and the policy implications of current capital requirements.

Government sites for the Treasury Department, the FDIC, and the Federal Housing Finance Agency provided primary source information on current and proposed banking regulatory policies.

Cornell University’s law research site, http://www.law.cornell.edu, has been a useful source for government legislation and regulations.

Weak Sources:

Newspaper articles (Washington Post, New York Times, etc.) that I found through the Google search tool provided inadequate references to primary sources. Although they would often cite the agency that released the information or data, links to the information source or references to the specific document were not available.

Blog entries and editorials provided varying opinions on the mortgage crisis and banking regulations. These opinions did not have the evidentiary weight of government or scholarly sources and were not inclusive of all factors that have an effect on the mortgage market.

The next step in my research strategy will be to search the Bank of International Settlements website, bis.org, for regulations regarding capital requirements. Nations vary on their implementation of the Basel Accord with respect to calculating risk and capital requirements, so a thorough search for U.S.-specific regulations will be required. Additional statistics on bank lending and portfolio composition – i.e. credit flow and capital holdings – should be located to provide a more complete picture of the current state of the banking industry.