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Financial Cleanup Steps for Congress—The Next Steps and Beyond

J. D. Foster, Ph.D.

Financial markets are under enormous strain despite vigorous efforts by the Treasury Department and the Federal Reserve to remedy the current crisis. Mostly one-off interventions, these efforts have proven inadequate, so Secretary Paulson announced a four-part program to deal with the markets' troubles on a more systemic basis. The most controversial and probably most important element of the Treasury package is a plan to allow the Treasury to purchase up to $700 billion in financial assets when markets for those assets appear to fail. This new initiative is intended to restore and preserve normal market functions by permitting troubled financial institutions to continue to correct their balance sheets. Congress must also ensure that it protects the taxpayers' interests.

Absent the actions proposed by Treasury, capital markets at home and worldwide would eventually normalize of their own accord, but at what cost to the rest of the economy? How long would such a process take, and how many non-financial businesses would fold in the meantime for lack of access to functional credit markets? The policies announced by the Treasury are extraordinary and could be justified only if the United States financial system is at risk and the broader economy is under threat of deep recession. The current situation appears to meet this test.

Congress should pass the necessary legislation quickly, and it should be very clear about the authorities of the new entity and especially about its mandate, carefully constraining that mandate to the task at hand: restoring markets while protecting taxpayers. Also, Congress should act without adding unrelated or loosely related provisions and pass the bill as stand-alone legislation.

Once a clean bill has been passed and signed into law, Congress should then address the many outstanding issues relating to the financial markets to prevent a recurrence of the current turmoil. These issues range from tax reform to financial market reform to a re-examination of federal policies toward home ownership to changes in certain accounting rules.

Quick Action—and Further Action—Needed. Congress needs to act carefully but quickly in passing this legislation, knowing that it can correct any flaws when it reconvenes next year. Quick action is needed because financial markets remain deeply stressed, and the stress continues to spread to the rest of the economy. But Congress must also pass a clean bill, avoiding the temptation to turn it into a Christmas tree of unrelated proposals. In particular, the bill should not include provisions redirecting any proceeds from the ultimate sale of assets away from Treasury's general fund. Nor should the bill be used as a vehicle for dictating private sector compensation or rewriting bankruptcy laws.

This paper, in its entirety, can be found at:
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Passage of financial legislation this week is important, but much remains to be done in follow-on legislation to address factors that contributed to the current turmoil. Here are some of the key issues Congress should take up:

- *Adopt Tax Policies to Encourage Recapitalization.* Many financial firms are in serious need of recapitalization. They need to raise additional equity capital to restore their balance sheets and participate again fully and normally with other financial participants and non-financial borrowers. To facilitate this process, Congress should allow these firms to issue new classes of common and preferred equity shares for which resulting capital gains and dividend income would be tax exempt.
- *Dissolve Fannie Mae and Freddie Mac.* The federal government seized Fannie Mae and Freddie Mac, and they are now operating under conservatorship. Congress should now pass legislation to put Fannie Mae and Freddie Mac on a clear path to eventual dissolution.
- *Reconsider Mark-to-Market Rules and Their Application.* An accounting rule known as "mark-to-market" has been blamed as a major factor contributing to weaknesses in financial markets. In brief, this rule requires firms to value the assets they hold at current market values rather than some other value such as its purchase price. Under most conditions, this rule is perfectly appropriate, as it contributes to more accurate valuation of assets and firms.

  However, when applied to assets traded in stressed markets or markets where normal trading has ceased, the mark-to-market rule results in the value of assets held in portfolio to be marked down below the fair value that would be established in the market under more normal conditions. Under the present circumstances, the mark-to-market rule has further and artificially impaired the capital of already weakened firms and has made it more difficult for market participants to gauge the value, capitalization, and ultimately the potential solvency of troubled firms. In short, mark-to-market rules have exacerbated the tendency of financial weakness to spread from firm to firm.

  Mark-to-market rules are set by a private entity, the Financial Accounting Standards Board (FASB). The FASB should reconsider the application of these rules under extraordinary circumstances. In no way should Congress undertake to dictate accounting standards, but there may be circumstances in which Congress may need to reconsider the effects of those standards with respect to bank capitalization rules, for example.
- *Revise the Community Reinvestment Act (CRA).* The CRA and other initiatives require banks and other financial institutions to better serve lower-income workers. While a worthy cause, the net effect is often to encourage loans at lower credit standards and to encourage people to buy houses they really cannot afford. As a result, too often they lose their homes, thereby losing savings that took a great effort to accumulate. Congress should revise these laws to ensure normal lending standards are maintained for all prospective mortgage borrowers.
- *Review Treasury and the Federal Reserve.* Recent events raise questions about the adequacy, or expansiveness, of authorities now exercised by the Treasury and the Federal Reserve. The Federal Reserve has vastly expanded on its traditional role as "lender of last resort," and the newly proposed entity of the Paulson plan creates a similar role but in a different bureaucracy. Congress should review carefully whether the management structure, authorities, and oversight of the Treasury and the Federal Reserve are correct for such roles.
- *Reform the Financial Regulatory System.* Current events underscore the need to modernize the nation's financial regulatory structure. The current regulatory structure of financial institutions is a patchwork of rules and regulations cobbled together over decades. This structure needs to be reformed to ensure the safety and soundness of the institutions and of the financial system as a whole. At the same time, efforts at reform must reflect the need to maintain the competitive strength of America's financial markets in providing services and capital to businesses and consumers at home and abroad.

- *Reform the Securities and Exchange Commission (SEC).* Questions have been raised in particular about the performance of the SEC and whether it has the authorities and resources needed to fulfill its intended role in protecting the soundness of financial markets and the safety of individual investors' positions. Congress should examine the performance of the SEC in the current episode to judge whether specific statutory changes are needed.

First Things First. Congress is working toward passage of legislation requested by the Administration that would create a new financial entity as part of the federal government to help restore financial markets while protecting taxpayers' interests. Once enacted, Congress should then turn its attention to the many areas that need to be improved to ensure a stronger economy and a sounder financial system for the future. These include:

- *Changes in tax policy to accelerate the recapitalization of weakened financial firms;*
- *The resolute dissolution of Fannie Mae and Freddie Mac;*
- *Correcting the effects of the mark-to-market accounting rule;*
- *Reforming the Community Reinvestment Act; and*
- *Fundamental reform of the financial markets.*

Federal interventions in the free markets over the years contributed to the current mess, and unfortunately, it will take a heavy dose of intervention to get us out again. But as it considers these issues in the months ahead, Congress should learn the lesson that when allowed to operate with as little federal meddling and bias as possible, markets remain the nation's most effective means of achieving prosperity.

—J. D. Foster, Ph.D., is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.