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IMF Wants U.S. Taxpayers to Shoulder More Risk

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The International Monetary Fund's (IMF) report on its 2014 Article IV consultation with the United States highlights the importance of securing a safer financial system. The IMF's policy recommendations would, however, achieve the opposite while putting U.S. taxpayers at risk.

IMF Report Gets Housing Finance Wrong

For starters, the IMF report states the U.S. should create a housing finance system that includes the following[1]:

- A substantial first-loss risk borne by private capital (rather than taxpayers),
- An explicit public backstop that is limited to catastrophic credit losses with risk-based guarantee fees, and
- A role for regulatory agencies in setting underwriting standards.

Most of these supposed reforms appear to be taken directly from the housing finance bills that recently stalled in the U.S. Senate. The main problem with these ideas is that they would leave the U.S. housing market in nearly the same state it was in before the 2008 financial crisis.[2]

One of the only real differences from these proposals and the pre-crisis U.S. housing finance market is that these plans would convert *implied* government backing into *explicit* government backing—hardly a win for U.S. taxpayers.

Under these proposals, new companies would replace the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, the two companies that were bailed out in 2008. These new companies, just like Fannie and Freddie, would be bailed out in the event of a catastrophic failure. The difference is that this bailout would be made explicit ahead of time instead of simply implied, as it was prior to 2008.

Supporters of the proposed Senate bills touted that the legislation would require more private capital (of the new firms) than the GSEs had. However, this argument ignores the fact that the GSEs started out with strong capital requirements. Congress has never been able to maintain adequate private capital requirements at these institutions, so there is simply no reason to expect a different result this time.

The IMF's recommendation is even stranger given its preoccupation with financial stability. The U.S. housing system, with a more extensive system of government guarantees in the housing market than nearly all other developed nations, suffered a more severe downturn than most countries.

For instance, U.S. volatility of home prices and home construction from 1998 to 2009 was among the highest in the industrialized world.[3] Furthermore, mortgage default rates in Western Europe and Canada were much lower than in the U.S., even amid rapidly falling home prices during the 2008 crisis.[4] None-

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theless, the IMF has decided to promote policies that would proliferate the less-stable U.S. system.

IMF Report Gets Financial Stability Wrong

Aside from these specific housing-finance-related policies, the IMF report promotes several broad themes that would give foreign regulators more power over U.S. companies and, most likely, destabilize financial firms around the globe.

The IMF report states:

> The U.S. should also continue to play a lead role in advancing the global regulatory reform agenda, ensuring common practices across countries, and limiting the opportunities for regulatory arbitrage.

One problem with this approach is that it mistakenly absolves regulators from contributing to breakdowns in financial markets. U.S. bank holding companies, for instance, have been regulated by the Federal Reserve for a century. In fact, after the 1999 Gramm–Leach–Bliley Act, the Fed was supposed to approve holding-company applications only after certifying that both the holding company and all of its subsidiary depository institutions were well-managed and well-capitalized. Clearly, there was a regulatory breakdown. Nonetheless, the IMF would give agencies such as the Fed even more regulatory authority.

Adopting one common framework would lead to more fragile financial markets. For instance, the Basel requirements (first implemented in the 1980s) encouraged firms to hold the same types of assets. A main cause of the recent crisis was that so many firms purchased mortgage-backed securities issued by Fannie Mae and Freddie Mac to lower their capital costs specifically because the Basel system assigned these assets low-risk weights.[5] As a result, the entire financial system was susceptible to any problems with just that one class of assets.

IMF Report Gets Capitalism Wrong

Even more broadly, it appears that the IMF favors a heavily regulated economy instead of a vibrant private capital market. The IMF report echoes several anti-market myths—as well as the so-called solutions to these supposed problems—currently being propagated by the Financial Stability Oversight Council (FSOC). The FSOC is the committee of regulators responsible for identifying so-called systemically important financial institutions (SIFIs).[6] The IMF report states:

> In particular, a tail risk where there was a precipitous attempt by investors to exit certain markets—perhaps exacerbated by outflows from ETFs and mutual funds as well as near-term market illiquidity—could trigger an abrupt and self-reinforcing re-pricing of a range of financial assets.

This passage amounts to an endorsement of the FSOC's report on asset management firms that suggests asset managers should be highly regulated

1. International Monetary Fund, "2014 Article IV Consultation with the United States of America Concluding Statement of the IMF Mission," http://www.imf.org/external/np/ms/2014/061614.htm (accessed July 23, 2014).
2. See John Ligon and Norbert Michel, "Fannie and Freddie 2.0: The Senate Does Not Get the Government Out of the Market," Heritage Foundation *Issue Brief* No. 4201, April 18, 2014, http://www.heritage.org/research/reports/2014/04/fannie-and-freddie-20-the-senate-does-not-get-the-government-out-of-the-market.
3. See John Ligon and Norbert Michel, "Why Is Federal Housing Policy Fixated on 30-Year Fixed-Rate Mortgages?," Heritage Foundation *Backgrounder* No. 2917, June 18, 2014, http://www.heritage.org/research/reports/2014/06/why-is-federal-housing-policy-fixated-on-30-year-fixed-rate-mortgages.
4. Ibid.
5. See Norbert Michel and John Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem," Heritage Foundation *Backgrounder* No. 2905, April 23, 2014, http://www.heritage.org/research/reports/2014/04/basel-iii-capital-standards-do-not-reduce-the-too-big-to-fail-problem?ac=1.
6. See Norbert Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail,'" Heritage Foundation *Backgrounder* No. 2900, April 1, 2014, http://www.heritage.org/research/reports/2014/04/the-financial-stability-oversight-council-helping-to-enshrine-too-big-to-fail.

because they allegedly cause systemic risk.[7] Asset managers buy only on behalf of their customers, so they collectively owe them nothing in the event of a market crash. Customers accept the risk, and asset managers merely transfer funds—their activity does not add to systemic risk.

Nonetheless, the FSOC is currently setting the stage to pre-identify large asset managers as SIFIs. This process would itself create systemic risk because it would announce to the market that the government will not let these firms fail. Because the FSOC's authority is so broad and the SIFI designation process is so ill-defined, all financial firms will face constant uncertainty over what sort of regulations will be handed down next.

Aside from this uncertainty, the process biases the financial system in favor of more risky behavior, because it minimizes the chances that creditors will lose money. Overall, the FSOC leads a massive top-down regulatory approach that can ultimately dictate to companies which financial activities are acceptable. This approach is wholly incompatible with a private market, and it should be avoided.

Hostile to Free Enterprise

The latest IMF report on its 2014 Article IV consultation with the U.S. is decidedly hostile to free enterprise. The report promotes a heavy-handed, top-down approach to financial regulations and explicit taxpayer backing of financial sectors. The IMF's policy recommendations would create a less stable financial system and put U.S. taxpayers at risk.

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7. See U.S. Department of the Treasury, Office of Financial Research, "Asset Management and Financial Stability," September 2013, http://www.treasury.gov/initiatives/ofr/research/Pages/AssetManagementFinancialStability.aspx (accessed July 23, 2014).