**Economic Crisis and Higher Education**

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## Future Prospects for the Credit and Capital Markets

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This panel of finance experts reviewed the roots of the financial crisis so as to shed light on how best to address it now and prevent another such crisis from occurring in the future. The panelists described their vision of the future structure of the banking industry and its regulatory mechanisms. They noted that the nation's five major investment banks no longer exist as such. Further, the securitization market that underpinned the new banking system is dead and likely to recover slowly, if at all, given the loss of trust throughout the financial system. Recovery of the financial industry also will be slow and bounded by stricter capital requirements that limit leveraging.

Key observations include:

- In the old, traditional banking system, capital requirements limited loans and growth. Regulatory efforts

designed to prevent bank collapses following the Savings and Loans crisis, however, rendered the financial system as a whole riskier because banks largely were made safer by figuring out ways to get their loans off their books.

- In the new banking system, investment banks and Fannie Mae and Freddie Mac bought loans from the banks, packaged them into securities, and sold them off to institutional investors. Risk was moved around and limited for its eventual holder via credit insurance, which was far underpriced.

- As banks sold off their loans and passed on their associated credit risks, bank lending standards plummeted. The system functioned as long as housing prices continued to rise.

- Numerous "villains" are responsible for the financial crisis, including federal policies to support home ownership; home buyers; mortgage banks; mortgage brokers; credit rating agencies; investment banks; institutional investors; and a loosened regulatory environment.

- A complete financial meltdown was prevented in October 2008 in large part because of the funds pumped into banks via the TARP. However, should the economy continue to deteriorate, even stronger institutions with solid underwriting standards will face serious problems too.

- Immediate solutions include injecting more capital into banks via TARP; purchasing banks' bad assets; and providing direct support to homeowners. However, these solutions are fraught with consequences: additional TARP funds balloon the cost of the bailout; the pricing of bad assets is extremely difficult; and direct support to homeowners and speculators is a moral hazard. It is likely, though, that some combination of these possibilities will be pursued.

- The immediate need to stabilize the financial system is clear. Longer-term, Washington must craft an exit strategy to address the Federal Reserves' balance sheet. The Fed's reserve bank credit has nearly doubled in the last several months, to $2 trillion, and its liabilities are nearly $800 billion, having multiplied nearly 80 times in the past year as the money base has blown up.

- The new, future lending model will depend much less on the securities market and will be far more regulated. In addition to the typical bank regulator, we can expect a "prudential" regulator focused on the capital held by banks; a business conduct regulator focused on transparency and protecting the investor; and a systemic risk regulator overseeing the entire system. Recovery of the financial industry will be slow, as growth will be tied to stricter capital requirements.

- The endowment model of investing has been successful in terms of long-term returns, even accounting for recent massive declines. The worst problem with endowments isn't a lack of diversification or low returns; rather, the importance of liquidity has been overlooked. Going forward, risk management must focus intensely on liquidity.