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The Myth of Financial Reregulation

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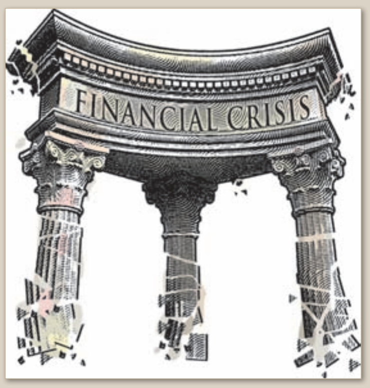
The regulatory reform bill currently before Congress will supposedly impose financial reregulation, reversing the alleged deregulation of the past 30 years. What deregulation? Can anyone point to the removal of a particular legal or regulatory barrier in the last two decades as a cause of the recent financial crisis? If so, will the new legislation restore this barrier?



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What the Bill Is Missing. The financial crisis is often blamed on Gramm-Leach-Bliley, a 1999 law that ratified the *de facto* breakdown of the separation between commercial banks and investment banks (which raise capital and market securities for governments and corporations). Repealing the law would return restrictions on banks' lines of business back to the Glass-Steagall Act passed in the Depression. But the new bill does not repeal Gramm-Leach-Bliley, and there is not much connection between it and the crisis.

In fact, to restore the distinction between commercial banking and investment banking would require an entirely new law. This is because Glass-Steagall did not contemplate such financial market innovations as money market funds, mortgage-backed securities or credit default swaps — all of which raise the question of whether they fall under commercial banking or investment banking.

Some point to government policies that encouraged home ownership as the cause of the crisis. However, property bubbles took place around the same time in many other countries, including the United Kingdom and Spain. These property bubbles cannot be blamed on U.S. housing policy. Moreover, this bill does not repeal any of the subsidies, such as the income tax deduction for mortgage interest, that encourage home buying.

Two federally chartered financial institutions, Freddie Mac and Fannie Mae, bought and sold mortgage-backed securities, and provided financing for individuals without the income necessary to repay them. But the proposed law does nothing to rein-in the mortgage giants.

Federal Reserve monetary policy helped fuel the housing bubble with low interest rates, but the most important cause of the crisis was a change in capital regulations. That was not deregulation, and it will not be reversed by the legislation.

The Role of Risk-Based Capital Requirements. The international Basel accords between the United States and other developed countries, as amended over the 1990s, required banks to hold capital based on the riskiness of their assets (such as loan portfolios). Previously, banks were required to hold capital equal to a percentage of different loan types. For example:

- The Basel agreement required 8 percent capital for most types of assets, including ordinary commercial loans.

- But for all mortgages, the agreement created an effective 4 percent capital requirement, regardless of risk.

Further, because banks were required to have much more capital for low-risk mortgage loans than Freddie Mac and Fannie Mae were required to have for their mortgage-backed securities — which were perceived to carry government guarantees — the risk weights made it advantageous to create mortgage-related securities.

- For mortgage securities guaranteed by Freddie Mac or Fannie Mae the capital requirement was 1.6 percent, about 40 percent of the requirement for commercial banks.
- A key change in the Basel regulations (effective in the United States January 1, 2002) broadened the definition of low-risk securities to include lower-rated ones (double-A or higher), which put them on par with Freddie Mac or Fannie Mae securities.

The 2002 rule dramatically lowered the capital banks needed in order to hold mortgage assets. The credit rating agencies that grade the risk of assets rated mortgage-backed securities too generously, under assumptions about house prices that were too optimistic. (Additionally, the Securities Exchange Commission voted in 2004 to ease capital requirements on investment banks.)

Regulatory Capital Arbitrage. Meanwhile, financial firms were devising ways to achieve regulatory capital arbitrage — gaming the system in order to minimize the amount of capital banks were required to hold while taking risks that offered higher rates of returns:

- Financial firms bundled and rebundled mortgage-backed securities, such as collateralized debt obligations (CDOs), and CDOs collateralized by CDOs (called CDOs-squared).
- They "rented" American International Group's (AIG) triple-A rating by obtaining credit default swaps (insurance against widespread mortgage defaults) from that insurance company.

"Deregulation didn't cause the crisis."

- Finally, banks moved mortgage securities off their balance sheets through special purpose vehicles (SPVs) and structured investment vehicles (SIVs), effectively evading capital requirements altogether.

As a result of these maneuvers, banks and other financial institutions became highly leveraged — taking on significant risks without commensurate capital. When housing prices fell, these institutions were forced to sell hard-to-value mortgage-backed securities or face bankruptcy. Overall:

- Commercial banks had insufficient capital to cover losses in their mortgage security portfolios.
- Freddie Mac and Fannie Mae had insufficient capital to cover the guarantees they had issued on mortgage securities.
- Investment banks, such as Merrill Lynch, had insufficient capital to cover losses on mortgage securities and derivatives.
- AIG had insufficient capital to cover the decline in value of its credit default swap portfolio.

Deregulation Isn't the Problem. Regulating financial innovation is much easier after the fact than before. Many innovations, such as the growth of hedge funds and private equity firms, were feared to pose risks, but they were not implicated in the recent crisis. On the other hand, mortgage credit scoring of home buyers seemed to be a relatively benign innovation — lowering transaction costs and broadening mortgage credit availability — yet it helped contribute to excessive subprime lending and securitization. Finally, risk-rating capital under the Basel accords was meant to increase the stability of the financial system by disclosing risk, but had the opposite effect.

The Federal Reserve and other U.S. regulators shaped and implemented bank capital requirements; they can change them under existing law. The problem is that regulatory design always solves problems in hindsight but often fails to anticipate the dynamic response of markets. Congress wants to give the Fed more authority over financial institutions, but more power is neither necessary nor will it be effective in preventing the next crisis. Legislation cannot create omniscient regulators out of fallible human beings.

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