REGULATORS AND THE FINANCIAL CRISIS
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By: James V. DeLong, VP & Senior Analyst, Convergence Law Institute. (Mr. DeLong is a former regulator, administrative law scholar, and Research Director of the Administrative Conference of the United States.)

The boiling debate over regulation of the financial system raises a series of difficult, interesting, and unusual issues. As Donald Rumsfeld would put it, there are the knowns, the known unknowns, and the unknown unknowns, and anyone who claims to grasp the totality is a true genius or absolutely mad, probably the latter.

For those who are neither, here are some of the factors at work.

+ Much reporting about the situation is nonsense, and a Gresham's Law of journalism is at work, as hysteria drives out rationality. The term "free fall" is applied to minor price declines, and, as Cato's Alan Reynolds notes, "credit crisis" is a silly term to apply to problems in valuation of exotic securities.

  Another example: the harping on "liars' loans." Fraud there was, but the rise of the "no doc" loan did not mean "no credit check"; indeed, the increased efficiency of credit reporting in the Internet Age was one reason why loans could become no-doc. In *The Big Switch*, tech guru Nick Carr updates the 1993 cartoon "on the Internet, nobody knows you're a dog" by noting that on today's Internet it is known not only that you're a dog but "what breed you are, your age, where you live, and the kind of treat you prefer."

+ Too much of the business press demonstrates a quite astonishing innumeracy and a preference for lurid adjectives and adverbs over hard facts. The discrepancy of view between those people who use numbers and those who don't is quite wide.

+ Speaking generally, government regulation usually consists of efforts to over-rule the market and attain outcomes that would not otherwise occur, often to transfer money to the benefit of powerful political players.

Financial regulation has to some degree broken free of this model in that the major players – the Fed, the Treasury, and the SEC – see their missions as making markets work efficiently and effectively, not over-ruling them. Agency judgment on how to accomplish this is sometimes wrong, but the theoretical goal is clear.

However, and this is a big caveat, regulatory judgment is most likely to go astray when old business models are getting hammered by change. The threat to powerful existing players is very likely to be interpreted as a threat to the market. This happened in the 1930s, when a major outcome of securities regulation was to reinforce a Wall Street monopoly that had been eroding.

Some of this may be occurring now. The old models of both commercial and investment banks are undermined by globalization and sovereign wealth funds, hedge funds and private equity, futures markets and the rise of the Chicago Mercantile Exchange. Do not discount the possibility that considerable of the screeching in the financial press is triggered by existing institutions that want to force Congress and the regulators to protect their current franchises.

\+ Because of the regulators' faith in markets, much current angst is caused by the fact that market mechanisms that were assumed to be solid did not work. For example, many have pointed out the principal/agent problem inherent in situations in which mortgage originators do not keep any of the credit risk. They also note the p/a problem when money managers have incentives to take on serious, but low probability, risk so as to reap rewards before the risk comes home to roost.

But guess what – these problems have been known forever. The clients in these situations were sophisticated financial operators who knew perfectly well that they faced p/a problems, who face such issues all the time, and who can deal with them by contract.

So the issue for the regulators to puzzle over is not dealing with p/a problems, but understanding why knowledgeable clients went wrong in dealing with them.

\+ Any idea that the goal is to make the market work goes out the window when housing is involved. For decades, rolling broadsides of propaganda and government policy, especially tax policy, have encouraged home ownership, even though many people would be better off to rent and put their savings into other instruments. The country would also be better off, since savings invested in housing are not going into productive capital goods. Furthermore, the worship of home ownership builds a serious inflationary pressure into the system. People think they are investing rather than consuming, and want to see a return, and it is a system where 10% of the value goes into transaction costs every time a house changes hands, so there must be constant paper value increases if losses are to be avoided.

The financial regulators know all this perfectly well. They will not mention it. Some shibboleths are too powerful.

But what we are now seeing is an interaction between this counter-productive national housing policy and the financial system. It is far from clear that the financial problems can be addressed in the long run without looking at housing.

It is equally unclear that housing issues can be addressed. Too many vested interests support each inefficiency of the current system.

So the odds are that our dysfunctional national housing policy will limp on, contaminating everything that it touches.

+ A run on a bank is not necessarily a disaster. The institutions are now being criticized for mis-matching the maturities to their assets and their obligations, but, since the business of financial institutions is to bridge the gap between the needs of savers and borrowers, they *always* borrow short term and lend long.

  If a bank has solid outstanding loans, then it can have a liquidity crisis if too many depositors want their money at the same time, but the result will be only that the bank must freeze its payments while it collects cash. The depositors get paid slowly, but they don't lose their money. If the loans are no good, the story is different. Then the bank has a solvency crisis, and the depositors will not get paid.

  Central banks deal with liquidity crises, loaning whatever immediate cash is needed against good collateral at a penalty interest rate, which is intended to incentivize the banks not to underestimate their cash needs. Deposit insurance deals with solvency crises for banks, and brokerage insurance is available for stockholders' accounts. These bulwarks have been and remain extremely important in the current crisis.

+ Mark-to-market accounting is getting the blame for some problems. (Mark-to-market means that instruments are valued at the price at which they are now trading, and not on the basis of their expected cash flow to maturity. Usually, these numbers are quite close, but when the market gets uncertain and panicky, mark-to-market can sink below a reasonable estimate of value to maturity.)

  Many of the firms at risk borrowed from banks and then put the money into mortgage instruments, at a slightly higher interest rate. To make money, they used leverage, sometimes 30 to 1 gearing or more: *e.g.*, start with $3 billion in capital, borrow $100 billion, and then buy $103 billion in mortgages, putting these as collateral against the borrowing. If the spread is 0.5%, then $3 billion in capital produces a revenue stream of over $500 million, rather better that the mere $150 million from investing the capital at 5%.

The potential problem is obvious; if the market value of the mortgages declines 3% (not exactly "free fall") the capital cushion is obliterated, and the loans become subject to calls for more collateral, which cannot be met without capital infusions.

This can happen if the market gets nervous even if the underlying paper is of good quality in the sense that holding it to maturity would produce full repayment, *viz* Thornburg Mortgage, a fine firm that got wiped out (and I speak with personal irritation here, since I looked at the subprime crisis, shrugged, and thought "what has this got to do with my Thornburg stock?")

This problem, like a run on a bank, is not necessarily a disaster. The firm can simply go into bankruptcy, collecting money on the mortgages and paying off its own creditors. If in fact the value of the mortgages, which is in the end determined by actual cash flow to maturity, is intact, then everyone will get paid. If the value has declined by 3%, everyone will get paid except the shareholders. If it has declined by more, the lenders will also take a hit.

Unfortunately, what works when one or a few institutions are involved breaks down when the problems are widespread, because bankruptcy equals gridlock, or falling dominoes, to mix the metaphor. The $100 billion that was loaned to the bankrupt firm gets frozen, which means that it is unavailable to pay the creditors of the lender, and so on down the line. Having the financial system seize up while everything is sorted out in bankruptcy courts is not a viable option.

The regulators are looking very closely at this issue of leverage, with a view to limiting its use, or developing some way to isolate contagion. Losing the bankruptcy circuit breaker raises severe problems, because then the need to closely regulate all the players will become overwhelming, and this is not the road to financial innovation.

\+ The Thornburg affair was a warning to regulators, but Bear Stearns was a deep trauma. On March 10, BSC had $18 billion in liquidity, well above requirements. Its borrowings were adequately secured. Then rumors started, and by March 13 the liquidity level was $2 billion, and bankruptcy papers were ready for filing the next morning. It was this that triggered drastic intervention by the Fed and the Treasury.

The agencies may have been wrong. Bankruptcy may have been the proper solution here. But the regulators had one chaotic all-nighter in which to decide whether the risk that defaults would cascade through the system were simply too great, and, given the stakes, no one has the right to second guess them.

It does raise, in spades, bankruptcy circuit breaker problem.

One certainty – if the Feds find out that there was a deliberate and manipulative bear raid on BSC, they will want to deal with the culprits in a manner designed to make Rome' Marcus Crassus look like a wimp. But in a globalized world, any such may be securely behind fire walls in Moscow, Tehran, or Peking.

+ The usual reaction of the political system to a crisis is to do something, often something stupid, such as Sarbanes-Oxley. As one DC figure says, "The [pick your party] is the stupid party and the [other] is the evil party; every once in while they agree to do something both evil and stupid and call it bipartisanship."

  Therefore, the Treasury Department was shrewd to release its comprehensive *Blueprint for a Modernized Financial Regulatory Structure*, a document in the works long before the current crisis. The proposals do not have a hope of passing any time soon, if at all, but their release pre-empts the field, making it politically difficult for Congress to act on whim, without adverting to the Treasury position.

  So bless Treasury for political savvy. (Of course, Secretary Paulson came from investment bank Goldman Sachs, where political naifs need not apply.) While Congress could do something precipitous, such as merge the SEC and the CFTC, just to show that it is on the job, the odds are that nothing as destructive as SOX will happen.

+ Through all this, the producing part of the economy is oddly unaffected. Companies have access to money, as bank loans have increased 8% since last August, and internal cash flows are high. There is a lack of connection between the financial turmoil and the outside world.

  Many theories are floating around: that pension funds needed high yielding securities, and that Wall Street found a way to meet the demand; that the housing industry and part of the financial services industry went off on a tangent that had little to do with the underlying economy; that U.S. commercial and investment banks are losing their franchises in the light of global money flows and are looking for other lines of work.

What does it all add up to? Who knows? No doubt the historians will some day explain why it all should have been perfectly clear. In the meantime, step up to the tables and place your bets. Thousands of flint-eyed Wall Streeters, who are highly numerate and not much affected by the hysteria of the press, are doing so. In the end, this is the constituency that the regulators care most about, because they all share the goal of keeping the system functional.