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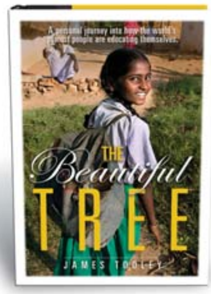

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Cato Policy Report

July/August 2009 Vol. XXXI No. 4

Did Deregulation Cause the Financial Crisis?

BY MARK A. CALABRIA

The growing narrative in Washington is that a decades-long unraveling of the regulatory system allowed and encouraged Wall Street to excess, resulting in the current financial crisis. Left unchallenged, this narrative will likely form the basis of any financial reform measures. Having such measures built on a flawed foundation will only ensure that future financial crises are more frequent and severe.

ROLLING BACK THE REGULATORY STATE?

Although it is the quality and substance of regulation that has to be the center of any debate regarding regulation's role in the financial crisis, a direct measure of regulation is the budgetary dollars and staffing levels of the financial regulatory agencies. In a Mercatus Center study, Veronique de Rugy and Melinda Warren found that outlays for banking and financial regulation increased from only $190 million in 1960 to $1.9 billion in 2000 and to more than $2.3 billion in 2008 (in constant 2000 dollars).

Focusing specifically on the Securities and Exchange Commission—the agency at the center of Wall Street regulation—budget outlays under President George W. Bush increased in real terms by more than 76 percent, from $357 million to $629 million (2000 dollars).

However, budget dollars alone do not always translate into more cops on the beat—all those extra dollars could have been spent on the SEC's extravagant new headquarters building. In fact most of the SEC's expanded budget went into additional staff, from 2,841 full-time equivalent employees in 2000 to 3,568 in 2008, an increase of 26 percent. The SEC's 2008 staffing levels are more than eight times that of the Consumer Product Safety Commission, for example, which reviews thousands of consumer products annually.

Comparable figures for bank regulatory agencies show a slight decline from 13,310 in 2000 to 12,190 in 2008, although this is driven completely by reductions in staff at the regional Federal Reserve Banks, resulting from changes in their check-clearing

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After eight years as a senior economist at the Senate Committee on Banking, Housing, and Urban Affairs, **MARK CALABRIA** joined the Cato Institute in April as director of financial regulation studies.

Venezuela's government did not want its citizens hearing the Cato Institute's message of freedom. Officials under Hugo Chávez sought to shut down a recent session of Cato University in the country, but failed to keep young Venezuelans from learning about the benefits of capitalism and individual liberty. Here, Venezuelan Chavistas protest Cato's activities in the country. **PAGE 12**

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activities (mostly now done electronically) and at the FDIC, as its resolution staff dealing with the bank failures of the 1990s was wound down. Other banking regulatory agencies, such as the Comptroller of the Currency —which oversees national banks like Citibank—saw significant increases in staffing levels between 2000 and 2008.

Another measure of regulation is the absolute number of rules issued by a department or agency. The primary financial regulator, the Department of the Treasury, which includes both the Office of the Comptroller of the Currency and the Office of Thrift Supervision, saw its annual average of new rules proposed increase from around 400 in the 1990s to more than 500 in the 2000s. During the 1990s and 2000s, the SEC issued about 74 rules per year.

Setting aside whether bank and securities regulators were doing their jobs aggressively or not, one thing is clear—recent years have witnessed an increasing number of regulators on the beat and an increasing number of regulations.

“Recent years have witnessed an increasing number of regulators on the beat and an increasing number of regulations.”

GRAMM-LEACH-BLILEY

Central to any claim that deregulation caused the crisis is the Gramm-Leach-Bliley Act. The core of Gramm-Leach-Bliley is a repeal of the New Deal-era Glass-Steagall Act's prohibition on the mixing of investment and commercial banking. Investment banks assist corporations and governments by underwriting, marketing, and advising on debt and equity issued. They often also have large trading operations where they buy and sell financial securities both on behalf of their clients and on their own account. Commercial banks accept insured deposits and make loans to households and businesses. The deregulation critique posits that once Congress cleared the way for investment and commercial banks to merge, the investment banks were given the incentive to take greater risks, while reducing the amount of equity they are required to hold against any given dollar of assets.

But there are questions about how much impact the law had on the financial markets and whether it had any influence on the current financial crisis. Even before its passage, investment banks were already allowed to trade and hold the very financial assets at the center of the financial crisis: mortgage-backed securities, derivatives, credit-default swaps, collateralized debt obligations. The shift of investment banks into holding substantial trading portfolios resulted from their increased capital base as a result of most investment banks becoming publicly held companies, a structure allowed under Glass-Steagall.

Second, very few financial holding companies decided to combine investment and commercial banking activities. The two investment banks whose failures have come to symbolize the financial crisis, Bear Stearns and Lehman Brothers, were not affiliated with any depository institutions. Rather, had either Bear or Lehman possessed a large source of insured deposits, they would likely have survived their short-term liquidity problems. As former president Bill Clinton told *BusinessWeek* in 2008, “I don't see that signing that bill had anything to do with the current crisis. Indeed, one of the things that has helped stabilize the current situation as much as it has is the purchase of Merrill Lynch by Bank of America, which was much smoother than it would have been if I hadn't signed that bill.”

Gramm-Leach-Bliley has been presented by both its supporters and detractors as a revolution in financial services. However, the act itself had little impact on the trading activities of investment banks. The off-balance-sheet activities of Bear and Lehman were allowable prior to the act's passage. Nor did these trading activities undermine any affiliated commercial banks, as Bear and Lehman did not have affiliated commercial banks. Additionally, those large banks that did combine investment and commercial banking have survived the crisis in better shape than those that did not.

DID THE SEC DEREGULATE INVESTMENT BANKS?

One of the claimed “deregulations” resulting from the mixing of investment and commercial banking was the increase in leverage by investment banks allowed by the SEC. After many investment banks became financial holding companies, European regulators moved to subject European branches of these companies to the capital regulations dictated by Basel II, a set of recommendations for bank capital regulation developed by the Basel Committee on Banking Supervision, an organization of international bank regulators. In order to protect its turf from European regulators, the SEC implemented a similar plan in 2004.

However the SEC's reduction in investment bank capital ratios was not simply a shift in existing rules. The SEC saw the rule as a movement beyond its traditional investor protection mandates to one overseeing the entire operations of an investment bank. The voluntary alternative use of Basel capital rules was viewed as only a small part of a greatly increased system of regulation, as expressed by SEC spokesman John Heine: “The Commission's 2004 rule strengthened oversight of the securities markets, because prior to their adoption there was no formal regulatory oversight, no liquidity requirements, and no capital requirements for investment bank holding companies.”

The enhanced requirements gave the SEC broader responsibilities in terms of the prudential supervision of investment banks and their holding companies.

DERIVATIVES AS FINANCIAL MISCHIEF

After Gramm-Leach-Bliley, the most common claim made in support of blaming deregulation is that both Congress and regulators ignored various warnings about the risks of derivatives, particularly credit default swaps, and chose not to impose needed regulation. In 2003, Warren Buffett called derivatives “weapons of mass financial destruction,” and warned that the concentration of derivatives risk in a few dealers posed “serious systemic problems." Buffett was not alone in calling for increased derivatives regulation.

But would additional derivatives regulation have prevented the financial crisis?

During her chairmanship of the Commodity Futures Trading Commission Brooksley Born published a concept paper outlining how the CFTC should approach the regulation of derivatives. Her suggestions were roundly attacked both by members of the Clinton administration, including Robert Rubin and Larry Summers, and by the leading members of the CFTC oversight committees on Capitol Hill.

Foremost among Born's suggestion was the requirement that derivatives be traded over a regulated exchange by a central counterparty, a proposal currently being pushed by Treasury secretary Timothy Geithner. Currently most derivatives are traded as individual contracts between two parties, each being a counterparty to the other, with each party bearing the risk that the other might be unable to fulfill its obligations under the contract. A central counterparty would stand between the two sides of the derivatives contract, guaranteeing the performance of each side to the other. Proponents of this approach claim a central counterparty would have prevented the concentration of derivatives risk into a few entities, such as AIG, and would have prevented the systemic risk arising from AIG linkages with its various counterparties.

The most basic flaw in having a centralized counterparty is that it does not reduce risk at all, it simply aggregates it. It also increases the odds of a taxpayer bailout, as the government is more likely to step in and back a centralized clearinghouse than to rescue private firms. In the case of AIG, Federal Reserve vice chairman Donald Kohn told the Senate Banking Committee that the risk to AIG's derivatives counterparties had nothing to do with the Fed's decision to bail out AIG and that all its counterparties could have withstood a default by AIG. The purpose of a centralized clearinghouse is to allow users of derivatives to separate the risk of the derivative contract from the default risk of the issuer of that contract in instances where the issuer is unable to meet its obligations. Such an arrangement would actually increase the demand and usage of derivatives.

> "The value of derivatives is that they allow the separation of various risks and the transfer of those risks to the parties best able to bear them."

Proponents of increased regulation of derivatives also overlook the fact that much of the use of derivatives by banks is the direct result of regulation, rather than the lack of it. To the extent that derivatives such as credit default swaps reduce the risk of loans or securities held by banks, Basel capital rules allow banks to reduce the capital held against such loans.

One of Born's proposals was to impose capital requirements on the users of derivatives. That ignores the reality that counterparties already require the posting of collateral when using derivatives. In fact, it was not the failure of its derivatives position that led to AIG's collapse but an increase in calls for greater collateral by its counterparties.

Derivatives do not create losses, they simply transfer them; for every loss on a derivative position there is a corresponding gain on the other side; losses and gains always sum to zero. The value of derivatives is that they allow the separation of various risks and the transfer of those risks to the parties best able to bear them. Transferring that risk to a centralized counterparty with capital requirements would have likely been no more effective than was aggregating the bulk of risk in our mortgages markets onto the balance sheets of Fannie Mae and Freddie Mac. Regulation will never be a substitute for one of the basic tenets of finance: diversification.

CREDIT RATING AGENCIES

When supposed examples of deregulation cannot be found, advocates for increased regulation often fall back on arguing that a regulator's failure to impose new regulations is proof of the harm of deregulation. The status of credit rating agencies in our financial markets is often presented as an example of such.

Credit rating agencies can potentially serve as an independent monitor of corporate behavior. That they have often failed in that role is generally agreed upon; why they've failed is the real debate. Advocates of increased regulation claim that since the rating agencies are paid by the issuers of securities, their real interest is in making their clients happy by providing the highest ratings possible. In addition they claim that the rating agencies have used their "free speech" protections to avoid any legal liability or regulatory scrutiny for the content of their ratings.

The modern regulation of credit rating agencies began with the SEC's revision of its capital rules for broker-dealers in 1973. Under the SEC's capital rules, a broker-dealer must write down the value of risky or speculative securities on its balance sheet to reflect the level of risk. In defining the risk of held securities, the SEC tied the measure of risk to the credit rating of the held security, with unrated securities considered the highest risk. Bank regulators later extended this practice of outsourcing their supervision of commercial bank risk to credit rating agencies under the implementation of the Basel capital standards.

The SEC, in designing its capital rules, was concerned that, in allowing outside credit rating agencies to define risk, some rating agencies would be tempted to simply sell favorable ratings, regardless of the true risk. To solve this perceived risk, the SEC decided that only Nationally Recognized Statistical Rating Organizations would have their ratings recognized by the SEC and used for complying with regulatory capital requirements. In defining the qualifications of an NRSRO, the SEC deliberately excluded new entrants and grandfathered existing firms, such as Moody's and Standard and Poor's.

In trying to address one imagined problem, a supposed race to the bottom, the SEC succeeded in creating a real problem, an entrenched oligopoly in the credit ratings industry. One result of this oligopoly is that beginning in the 1970s, rating agencies moved away from their historical practice of marketing and selling ratings largely to investors, toward selling the ratings to issuers of debt. Now that they had a captive clientele, debt issuers, the rating agencies quickly adapted their business model to this new reality.

The damage would have been large enough had the SEC stopped there. During the 1980s and 1990s, the SEC further entrenched the market control of the recognized rating agencies. For instance, in the 1980s the SEC limited money market funds to holding securities that were investment grade, as defined by the NRSROs. That requirement was later extended to money market fund holdings of commercial paper. Bank regulators and state insurance commissioners followed suit in basing their safety and soundness regulations on the use of NRSRO-approved securities.

The conflict of interest between raters and issuers is not the result of the absence of regulation, it is the direct and predictable result of regulation. The solution to this problem is to remove the NRSROs' monopoly privileges and make them compete in the marketplace.

PREDATORY LENDING OR PREDATORY BORROWING?

As much of the losses in the financial crisis have been concentrated in the mortgage market, and in particularly subprime mortgage-backed securities, proponents of increased regulation have argued that the financial crisis could have been avoided had federal regulators eliminated predatory mortgage practices. Such a claim ignores that the vast majority of defaulted mortgages were either held by speculators or driven by the same reasons that always drive mortgage default: job loss, health care expenses, and divorce.

The mortgage characteristic most closely associated with default is the amount of borrower equity. Rather than helping to strengthen underwriting standards, the federal government has led the charge in reducing them. Over the years, the Federal Housing Administration reduced its down-payment requirements, from requiring 20 percent in the 1930s to the point today that one can get an FHA loan with only 3.5 percent down.

The predatory lending argument claims that borrowers were lured into unsustainable loans, often due to low teaser rates, which then defaulted en masse, causing declines in home values, which led to an overall decline in the housing market. For this argument to hold, the increase in the rate of foreclosure would have to precede the decline in home prices. In fact, the opposite occurred, with the national rate of home price appreciation peaking in the second quarter of 2005 and the absolute price level peaking in the second quarter of 2007; the dramatic increase in new foreclosures was not reached until the second quarter of 2007. While some feedback between prices and foreclosures is to be expected, the evidence supports the view that initial declines in price appreciation and later absolute declines in price led to increases in foreclosures rather than unsustainable loans leading to price declines.

Normally one would expect the ultimate investors in mortgage-related securities to impose market discipline on lenders, ensuring that losses stayed within expectations. Market discipline began to breakdown in 2005 as Fannie Mae and Freddie Mac became the largest single purchasers of subprime mortgage-backed securities. At the height of the market, Fannie and Freddie purchased over 40 percent of subprime mortgage-backed securities. These were also the same vintages that performed the worst; subprime loans originated before 2005 have performed largely within expectations. Fannie and Freddie entering this market in strength greatly increased the demand for subprime securities, and as they would ultimately be able to pass their losses onto the taxpayer, they had little incentive to effectively monitor the quality of underwriting.

CONCLUSION

The past few decades have witnessed a significant expansion in the number of financial regulators and regulations, contrary to the widely held belief that our financial market regulations were "rolled back." While many regulators may have been shortsighted and over-confident in their own ability to spare our financial markets from collapse, this failing is one of regulation, not deregulation. When one scratches below the surface of the "deregulation" argument, it becomes apparent that the usual suspects, like the Gramm-Leach-Bliley Act, did not cause the current crisis and that the supposed refusal of regulators to deal with derivatives and "predatory" mortgages would have had little impact on the actual course of events, as these issues were not central to the crisis. To explain the financial crisis, and avoid the next one, we should look at the failure of regulation, not at a mythical deregulation. ■