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Working Paper No. 585

Is Reregulation of the Financial System an Oxymoron?*

by

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ABSTRACT

The extension of the subprime mortgage crisis to a global financial meltdown led to calls for fundamental reregulation of the U.S. financial system. However, that reregulation has been slow in implementation and the proposals under discussion are far from fundamental. One explanation for this delay is the fact that many of the difficulties stemmed not from lack of regulation but from a failure to fully implement existing regulations. At the same time, the crisis evolved in stages, interspersed by what appeared to be the system's return to normalcy. This evolution can be defined in terms of three stages (regulation and supervision, securitization, and a run on investment banks), each stage associated with a particular failure of regulatory supervision. It thus became possible to argue at each stage that all that was necessary was the appropriate application of existing regulations, and that nothing more needed to be done. This scenario progressed until the collapse of Lehman Brothers brought about a full-scale recession and attention turned to support of the real economy and employment, leaving the need for fundamental financial regulation in the background.

Keywords: Financial Regulation; Financial Crisis; Subprime Crisis; Mortgage Affiliate Regulation

JEL Classifications: G21, G24, G28

I. THREE STAGES OF THE CRISIS

The current financial crisis can be characterized in three distinct stages. Each new stage of the crisis can be linked to a failure to apply existing regulations or a failure of regulation. This has opened the way to a response to the crisis that avoids structural reform of the financial system and instead focuses on more effective application of existing regulations or improvements in those regulations. As a result, despite widespread expectations that the severity of the crisis would lead to fundamental reform similar to that of the New Deal period, reregulation of the financial system has been minimal.

After the increase in defaults and the reversal of house prices in 2006 led to the insolvency of several large mortgage originators, such as New Century and Countrywide, in the spring of 2007, attention was focused on the regulations governing mortgage lending. This was the stage in which the crisis was considered to have been “contained.” Despite discussions of fraudulent lending and measures to rescue borrowers, little has been done in either respect. Losses were contained in the sense that they were primarily absorbed by the households who could no longer meet their payments on nontraditional mortgages. The bankruptcy judge dealing with New Century recommended that management be tried for fraud and required to repay bonuses that had been paid against fictitious profits generated by inaccurate and probably fraudulent bookkeeping practices. In December, the SEC announced that it would press charges against three members of the top management. The Fed eventually responded by amending Regulation Z (Truth in Lending) under the Home Ownership and Equity Protection Act (HOEPA) in July of 2008.

Long before the Fed had moved to act, the impact of mortgage defaults had reduced the value of the mortgages contained in the securitized assets that had been originated by banks. This caused losses in the securitized structures and directed attention to the monoline insurers and the contingent liquidity guarantees, credit default swaps, and other over-the-counter derivative contracts that were supposed to cover these losses. As many banks had also provided similar guarantees, the losses meant they had to be recognized on their balance sheets and charged against the banks’ capital base under existing capital adequacy requirements and the revision of the as yet to be fully introduced Basel II capital requirements. The Basel Committee is still at work on these revisions. In response to these losses, banks raised additional capital and, once

again, the view prevailed that the crisis was contained by the Fed-engineered rescue of Bear Stearns via a pass-through loan from JP MorganChase. This support was eventually institutionalized in a special Federal Reserve facility that was extended to all U.S. government securities dealers.

Finally, in September of 2008, the insolvency of Lehman Brothers' mortgage and real estate units produced a complete collapse of short-term money markets, including money market mutual funds. This time the problem facing the system was considered to be liquidity, not capitalization, and the response was a full FDIC guarantee of virtually all short-term liabilities of financial institutions in the system and opening the discount window to all private sector business and to allow virtually all assets to serve as collateral. The aim was to avoid an old-style run on financial institutions. The Fed allowed its balance sheet to expand to absorb the financial assets that the private sector was no longer willing to hold. As Richard Kahn pointed out long ago, it is the role of the banking system to hold the assets that the public chooses not to hold, and it is the role of the central bank to hold the assets that the private financial system chooses not to hold. The Fed thus liquefied the portfolio holdings of the private sector by providing cash in exchange. For the banks this involved expansion of their reserve account balances and, in addition, the Fed started to offer interest on the gross reserve positions of the banks.

The difficulty with this response to the crisis is that it was always reacting to a particular failure of the existing system and attempting to provide changes in regulation to restore the normal functioning of the particular sector in difficulty. If the problem was subprime mortgages, then introduce regulations to deal with the problems created by subprime mortgages; if the problem was capital adequacy, revise the capital adequacy regulations; if the problem was insufficient liquidity, introduce more stringent liquidity requirements. But, if it is the "normal" functioning that is the problem, then simple repair will never produce reregulation of the system.

As Minsky has emphasized since his earliest work on financial market regulation, it is impossible to design regulations that increase the stability of financial markets if you do not have a theory of financial market instability. If the "normal" precludes instability, except as a random ad hoc event, regulation will always be dealing with ad hoc events that are unlikely to occur again. As a result, the regulations are powerless to prevent future instability. Instead, Minsky argued that what was required was a theory in which financial instability was a normal

occurrence in the system. Only on the basis of such a theory could regulation be designed and understood.

This paper will consider in more detail the regulatory failures that contributed to the developments in each stage of the current crisis as a background to the design of more effective regulation and the regulatory measures that were put in place in response.

II. STAGE ONE: REGULATION AND SUPERVISION OF MORTGAGE LENDING— UNREGULATED MORTGAGE AFFILIATES

While it has been argued that mortgage lending was subject to lax regulation, this is not precisely true. It would be more correct to say that existing regulations were not applied and that supervision was lax by design, rather than by oversight.

According to the Mortgage Brokers Association, “Mortgage brokers are regulated by more than ten federal laws, five federal enforcement agencies and at least forty-nine state regulation and licensing statutes. Moreover, mortgage brokers, who typically operate as small business owners, must also comply with a number of laws and regulations governing the conduct of commercial activity within the states” (National Association of Mortgage Brokers, November 2006).²

In addition,

“Mortgage brokers are licensed or registered and must comply with prelicensure and continuing education requirements and criminal background checks in forty-nine states and the District of Columbia. Additionally, over half of these states require not only mortgage broker licensure, but the licensure or registration of brokers’ individual loan officers as well. An increasing number of states are requiring these originators to pass tests in order to become licensed.” (National Association of Mortgage Brokers 2006)

² “Mortgage brokers are governed by a host of federal laws and regulations. For example, mortgage brokers must comply with: the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), the Home Ownership and Equity Protection Act (HOEPA), the Fair Credit Reporting Act (FCRA), the Equal Credit Opportunity Act (ECOA), the Gramm-Leach-Bliley (GLB) Act, and the Federal Trade Commission Act (FTC Act), as well as fair lending and fair housing laws. [...] Additionally, mortgage brokers are under the oversight of the Department of Housing and Urban Development (HUD) and the Federal Trade Commission (FTC); and to the extent their promulgated laws apply to mortgage brokers, the Federal Reserve Board, the Internal Revenue Service, and the Department of Labor.” National Association of Mortgage Brokers (2006). See http://www.namb.org/Images/namb/GovernmentAffairs/Word_From_Washington/WFW%202006-11%20%28Regulation%20of%20Brokers%29.pdf.

However,

“The same is not true for the thousands of loan officers employed by mortgage bankers and other lenders, who are exempt in most states from loan officer licensing statutes. While the Office of the Comptroller of the Currency exempts depository institutions from state licensing requirements, the states continue to increase their regulation of mortgage brokers and their individual loan officers. Many states also exempt lenders from licensing if they are approved by Fannie Mae or HUD, which subjects those lenders and their employees to significantly less regulation than most mortgage brokers. As small businessmen and women, mortgage brokers must also comply with numerous predatory lending and consumer protection laws, regulations and ordinances (i.e., UDAP laws). Again, this is not true for a great number of depository banks, mortgage bankers, mortgage lenders and their employed loan officers, which remain exempt due to federal agency preemption. Many states also subject mortgage brokers to oversight, audit and/or investigation by mortgage regulators, the state’s attorney general, or another state agency, and in some instances all three.” (National Association of Mortgage Brokers 2006)

Consumer protection organizations have provided extensive evidence concerning the failure of regulatory agencies to apply existing regulations.³ Even before the introduction of the Financial Modernization Act (GLB) in 1999, bank holding companies had opened mortgage affiliates, or purchased independent consumer finance companies that had entered the market for subprime mortgages. Even though the Fed was granted responsibility for the supervision of bank holding companies, it decided that these affiliates would not be supervised for compliance with federal laws protecting borrowers since they had not been previously subject to regulation. In January 1998, the Board of Governors unanimously decided to formalize a long-standing practice, “to not conduct consumer compliance examinations of, nor to investigate consumer complaints regarding, nonbank subsidiaries of bank holding companies.” This decision was then applied to any nonbank financial institution that became the affiliate of a bank holding company. A 1999 report by the General Accounting Office (GAO) warned that the Fed’s decision created “a lack of regulatory oversight,” because the Fed alone was in a position to supervise the affiliates. Its role as regulator of bank holding companies was strengthened in the GLB Act, but

³ See Responsible Lending, “Neglect and Inaction: An Analysis of Federal Banking Regulators’ Failure to Enforce Consumer Protections,” <http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/regulators-failure-to-enforce-consumer-protections.html>.

was only exercised for mortgages originated through the banking affiliate of the holding company.

Thus, just as banks were moving their capital exposure to mortgage lending off balance sheet through the creation of special purpose entities, they moved these activities outside the purview of regulators by creating and acquiring mortgage affiliates that were technically regulated, but had been declared outside the purview of Fed supervision. As a result, around 13 percent of the national total of subprime loans made between 2004 and 2007 by bank affiliates were de facto unregulated, even though the Federal Reserve had de jure power to do so. A 2000 joint report on predatory lending by the Treasury Department and the Department of Housing and Urban Development (HUD) had noted the failure of the Fed to use its authority to investigate evidence of abusive lending practices and urged a policy of targeted examinations, long before the current abuses commenced.⁴

The regulatory response to this failure to exercise regulatory agency was quite simply to make sure that the abuses in the existing system were eliminated. According to a Washington Post article, “The Fed’s performance was undercut by several factors, according to documents and more than two dozen interviews with current and former Fed governors and employees, government officials, industry executives and consumer advocates. It was crippled by the doubts of senior officials about the value of regulation, by a tendency to discount anecdotal evidence of problems and by its affinity for the financial industry.” This seems to be a clear example of the damage that can be done by applying regulations on the basis of a model in which financial instability is an exceptional, rather than a normal, occurrence. It clearly limited the ability of supervisors to see beyond the problem of the unregulated mortgage affiliates to the wider question of the impact on the solvency of the bank holding companies themselves.

⁴ “As Subprime Lending Crisis Unfolded, Watchdog Fed Didn’t Bother Barking,” by Binyamin Appelbaum, Washington Post, Sunday, September 27, 2009.
http://www.washingtonpost.com/wp-dyn/content/article/2009/09/26/AR2009092602706_pf.html.

III. STAGE TWO: MORTGAGE SECURITIZATION—UNREGULATED OFF-BALANCE-SHEET AFFILIATES

Although house prices had stopped increasing in many areas by early to mid-2006, and defaults and foreclosures had reached a sufficient level to cause distress and eventual bankruptcy for some of the larger mortgage originators (such as New Century) in the first quarter of 2007, it was only the discovery of the contingent liabilities that many large financial holding companies had issued to arms-length special investment vehicles (SIVs) that brought the second phase of the mortgage crisis. It is interesting that at this stage the viability of the securitized subprime loan vehicles, their AAA credit ratings, and the role of monoline insurers and credit default swaps in supporting those ratings had yet to fully appear. Rather, it was the absence of variable interest on SIVs on the reported balance sheets of banks and the regulations that governed their accounting procedures. These entities were the result of two trends in the financial markets of the 1980s that broke the barriers between fixed interest securities and equities through the invention of the junk bond.

In 1998, two Citibank employees, Stephen Partridge-Hicks and Nicholas Sossidis, set up a fund that would issue short-term commercial paper and medium-term notes to investors and use the money to buy higher-yielding, longer-term collateralized obligations of commercial real estate or credit card receivables that were just being perfected. The fund's assets would belong to the holders of the medium-term notes, who would be responsible for the fund's debt if the commercial paper funding dissolved. The assets would thus stay off the bank's balance sheet, but would generate fees from originating the assets and organizing and servicing what was to become the model for the SIV and a major destination for bank-securitized subprime loans.

The second element that supported the use of SIVs was the regulatory response to the use of off-balance-sheet entities after the Enron bankruptcy. Enron had used these special vehicles for a different purpose—the generation of income from fictitious sales that allowed the company to manipulate its reported earnings figures and, thus, its stock price. For banks, the advantage lay in the ability to remove the entities from their consolidated reporting, thereby reducing or eliminating the amount of regulatory capital that had to be held against them. The regulatory adjustment to accounting requirements for off-balance-sheet entities were thus driven by different needs and to eliminate a different problem than was at issue at Enron. The resulting

changes provided substantial support for the use of such entities by banks after the new regulations were introduced in 2002.

The United States Accounting Standards Board restricted the use of off-balance-sheet accounting in the wake of Enron. The original rules had been based on the share of equity ownership in the entity. The share at which consolidation would be required was set by interpretation at 3 percent of total equity. Thus, in the case of Enron, it was not required to consolidate any special entity in which it had less than 97 percent of the equity ownership. The problems at Enron were created by the fact that Enron employees were providing the 3 percent with funds lent to them by Enron.

The new Financial Accounting Standards Board (FASB) accounting rules moved away from a simple share of owners' equity and concentrated on effective control through the ability to influence the daily operations of the company and the assignment of loss if there were a decline in asset values. This revision created the variable interest entities, or VIEs, as the post-Enron version of special-purpose vehicles, the term for the investments Citigroup created that led to the demise of the energy-trading company. The SIV provided a perfect example of a qualifying VIE since the originating bank had no equity interest, nor did it bear the first risk of loss if the commercial paper could not be rolled over and the assets sold at a loss. They thus became a repository for the AAA tranches of the securitized subprime mortgage obligations, but were not reported on any major bank's consolidated balance sheet; nor did the assets require provision of bank capital.

When troubles with subprime mortgage loans became an issue in the summer of 2007, SIVs didn't appear to be affected because it was thought that few had exposure to subprime loans. In July, Moody's Investors Service considered SIVs "an oasis of calm in the subprime maelstrom." However, by late July, a bank affiliate set up by German bank IKB Deutsche Industriebank reported funding difficulties and, in August, Cheyne Finance (a \$6.6 billion SIV operated by a London hedge fund) began liquidating assets to repay debts. On September 6, Citibank announced that its SIVs had little subprime exposure, but that they were also selling assets.

Thus, the subprime mortgage lending carried out by a large bank holding company could escape supervision if it took place in a mortgage affiliate. The mortgages the affiliate generated could escape market scrutiny if they were packaged into collateralized mortgage obligations that

were sold to SIVs that were not subject to supervision of capital adequacy and were regulated, if at all, as Section 144 assets under the SEC. Sales of such assets are considered as private transactions whose contents and details need only be provided to the buyers of the securities.

Again, there was no lack of formal regulation; indeed the SIVs were made possible by reregulation that was supposed to prevent the kind of abuse of off-balance-sheet entities that had occurred under Enron. Many banks had written liquidity puts similar to back-up lines of credit to the issue of commercial paper by a private company that required the banks to cover the difference between the liquidation value of the subprime collateralized mortgage obligations (CMOs) and the commercial paper falling due. When the implications of these contracts were made public, the response was to create a rescue entity funded by private banks to absorb the assets and prevent their sale while urging banks to recapitalize to cover any potential losses. At this stage, many large banks sought capital injections from sovereign wealth funds or wealthy individual investors such as Middle Eastern oil sheiks or Warren Buffet. In the end, many banks simply took the assets back onto their balance sheets, given that most still carried AAA ratings. Again, the response was to provide a remedy that reinforced the application of existing regulations and repaired the damage from faulty application by replenishing bank capital. This discussion now focuses on the active or passive ability of the originating bank to influence day-to-day operations and on requiring an ongoing assessment of the classification of variable interest entities when the risk exposure of the bank changes over time. Basically, the solution was simply seen as providing enough capital to allow the banks to take the assets back on their balance sheets and to meet residual losses due to the relatively small proportion of subprime mortgages involved.

Thus, by the end of 2007 and the beginning of 2008 it was again believed that the subprime exposure problem was well contained. Well contained because it was believed that the system would now revert to normal, having taken care of the mortgage affiliates and the off-balance-sheet affiliates. The stage was set for the third stage that started in March with the collapse of Bear Stearns and ended with the bankruptcy of Lehman and brought the entire financial system to a halt.

IV. STAGE THREE: A RUN ON INVESTMENT BANKS

The third stage of the crisis occurred not in the traditional fashion of a deposit run (although there were lines of depositors seeking to remove their funds from Northern Rock in the UK). Rather, it occurred in the investment banking sector, the sector that is supposed to be immune to such panics and, if it does experience difficulty, is supposed to be able to resolve bankruptcy without disrupting the payments system. The application of mark-to-market accounting has played a substantial role in the discussions of the evolution of the crisis. Its genesis, however, provides a clue to the problems that were faced in the third stage of the crisis. Mark-to-market accounting was originally applied by the Securities and Exchange Commission (SEC) in assessing capital requirements for broker-dealer investment banks. The idea was that a broker-dealer would, in general, finance its inventory with short-term funding. The classic case in the pre-GLB world was the specialist on the New York Stock Exchange who financed inventory of stock by using it as collateral for call money borrowed from a New York deposit-taking, insured bank. Since funding had to be renewed daily (or, indeed, on call) the collateral had to be repriced (marked to market) every day to insure that its value was sufficient to repay the borrowing from the banks. The capital requirement was the equivalent of the haircut on the value of the securities, or the margin of error, to ensure that the broker-dealer was truly solvent and could meet all of its short-term obligations. The viability of any investment bank thus depended on the value of its inventory of assets and its ability to refinance those assets on a more or less continuous short-term basis. We have already seen how in the second stage of the crisis doubts over the value of the assets held by SIVs led to difficulty in refinancing via the failure of investors to buy its asset-backed commercial paper. That experience led to doubts about the ability of commercial banks to meet their lending commitments in support of subprime mortgage assets, but the entire financial system was operating on the same basis of borrowing short-term funds to finance the origination, the underwriting, and, subsequently, the positions in mortgage assets.

One of the main characteristics of the deregulation that brought about the erosion of the Section 20 restrictions on bank activities was the creation of the securities repurchase (or “repo”) market in which banks would lend against collateral, initially government securities. This meant that an uninsured financial institution could finance its assets holdings through a repurchase

agreement with an insured commercial bank. In this arrangement, the bank was lending short term to finance speculative holdings of government and other securities. Eventually, investment banks learned that they could lend to their clients, such as hedge funds, to support their speculative positions by lending the securities of the hedge funds they held as collateral. It was thus possible for a hedge fund to attain leverage ratios of 20 to 40 by borrowing from an investment bank using the securities it was speculating on as collateral, with the investment bank then raising the funds it lent to the hedge fund by using the securities as collateral for a repo from an insured bank that was itself leveraging by a similar amount using the securities held as collateral for the hedge fund client. In this relationship, called a prime brokerage account, the investment bank provided the hedge fund not only with leveraged funding for its investments, but also the execution of its trades and other technical and administrative services, all of which earned fee and commission income for the investment bank. The main point is that an increasingly long chain of short-term lending or financial layering was supporting speculative positions in long-term assets with increasing leverage. At the basis of the system was a deposit-taking bank affiliate of a financial holding company. The subprime mortgage obligations that were being funded were also serving as collateral. This system would have been extremely fragile and subject to collapse even if the mortgage assets had been perfectly sound, which they were not.

Indeed, the problems on the asset side were not only because of the increasing defaults due to the onerous terms and fraudulent origination activity. A collateralized obligation is not a standard security, i.e., the liability of a chartered private corporation. It is a financial institution, usually a trust, and it issues securities whose credit rating is determined by the structure of the liabilities and the owners' equity. This owners' equity was the medium-term note in the SIV. In a CMO it is the equity tranche (usually no more than 4 or 5 percent of the total asset value) that is usually supplemented by a guarantee given by a monoline insurer who has far less than 1 percent of assets against its liabilities, or by a credit default swap written by another bank or by AIG, in which case the reserve is not even 1 percent. The AAA credit ratings that were given to 90 to 95 percent of the value of the assets issued as securities thus were the equivalent of being reserved by short-term money. Borrowing by the insurers would be required to meet the guarantees. Therefore, there was leverage on both sides of the balance sheets of financial institutions—their assets were leveraged and their liabilities were leveraged.

When questions were raised, first about Lehman and then about AIG, it was as if the short-term loans and margin guarantees were called on both sides of the balance sheet and the result was the equivalent of a bank run, not on deposit banks, but on the investment banks. Since the deposit banks were already facing capital constraints due to their own SIVs, they could not provide funding to meet the margin calls and it had to come from other investment banks. However, they were all looking for alternative funding for their asset holdings, as were the insurers. The hedge funds, fearing loss of their assets, held on to their prime brokerage accounts, sought assurance, and started to withdraw their funds. Faced with the impossibility of returning the cash and assets in the accounts (since they were pledged as collateral funding their asset positions), the only alternative would have been to attempt to raise cash by selling assets in conditions in which there were no buyers. This would have led to zero prices and the application of mark to market in these conditions would have clearly led to insolvency of the entire system.

It was at this stage that the Treasury and the Fed decided that a systemic solution was required to support asset prices; this was achieved through the request to Congress for TARP funding and the Fed decision to lend to any and all institutions to allow them to meet short-term funding requirements. It handsomely proved Minsky's rule that the stability of an institution depends only on the ability to sell assets for cash and only the Fed can provide cash in unlimited amounts.

V. CONCLUSION

There was no lack of regulation governing the financial institutions that engaged in the buildup of financial layering and pyramiding on an ever-declining cushion of cash. The response has been to try to improve and better apply those regulations while implementing short-term liquidity measures to stabilize asset values. Indeed, the fundamental problem is believed to have been the collapse in asset prices created by the disappearance of market liquidity, rather than any inherent problem with the assets themselves. However, if the assets are insolvent, as are the institutions that hold them, this approach cannot provide for the recovery of the system. The failure to recognize this fact is at the root of the failure to provide any meaningful reform of the system. As long as the policy is to provide sufficient liquidity in the hope that asset prices will return to

levels that allow banks to remain solvent with minimum capital injections, there can and will be no meaningful reform or regulation of the financial system.