CHAPTER – VI: The Subprime Crisis & Financial Regulation - International and Comparative Perspectives

Contents

The Subprime Crisis and Financial Regulation International & Comparative Perspectives................... 3
FINANCIAL INSTITUTIONS IN EUROPE AND THE.......................................................... 8
UNITED STATES................................................................................................................................ 8
A. Banks in Germany .................................................................................................................. 9
B. Banks in the United States .................................................................................................. 10
C. Banking regulation ........................................................................................................... 12
1. Safety and Soundness Regulation ..................................................................................... 13
2. Is there a better way to regulate? ...................................................................................... 20
3. European Fragmentation .................................................................................................. 25
4. The Shadow Banking System .......................................................................................... 26
THE ROLE AND CHALLENGES OF REGULATION: ...................................................... 28
WHY REGULATE BANKS AT ALL? ................................................................................ 28
A. The Subprime Issue in Europe .......................................................................................... 31
B. The Securitization Process And the Subprime Crisis ....................................................... 34
A SUMMARY OF THE CAUSES BEHIND THE ................................................................. 41
REGULATORY FAILURE......................................................................................................... 41
The global subprime crisis that erupted in mid-2007 unleashed a torrent of analysis in the US. Its impact in some other countries equaled or exceeded that in the US, in part because financial institutions elsewhere in the world purchased securities issued by US-based financial institutions and secured by mortgages on US real estate. The spread of the subprime crisis abroad has several implications. The reach and impact of the “made in America” subprime crisis has generated an urgent international issue engaging many central banks and finance ministries, as well as a wide variety of international bodies, especially the Basel-based international institutions, such as the Financial Stability Forum (renamed the Financial Stability Board in 2009) and the Basel Committee on Banking Supervision. The purchasers of these US mortgage securities were not simply victims. Many of the world’s most sophisticated banks bought these securities, usually without doing their own investigation and analysis and almost certainly without adequate due diligence. And they did so because, like many US purchasers, they sought higher returns than elsewhere available.

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The underlying theme of this paper is thus that an analysis of the subprime crisis and proposed solutions is incomplete if international and comparative perspectives are not brought to bear. Contrary to popular impression, securitization (the pooling of loans, including mortgage loans, into securities) is common throughout the world^2^.

In Germany, mortgage-backed securities have been common for at least 200 years. In Asia, securitization markets had been growing, in part because of the underdeveloped state of Asian bond markets^3^. Indeed, US authorities have often looked to European precedents for reform. For example, a US Secretary of the Treasury called for adoption of the European institution of "covered bonds" for financing home mortgages.

The crisis was "an accident waiting and ready to happen"^4^ based on very low interest rates in the US, UK and the Eurozone; the "Great Moderation" (an unparalleled period of low and stable inflation); and the tendency of the Federal Reserve during the chairmanship of Alan Greenspan to increase liquidity and lower target interest rates promptly whenever financial markets weakened sharply, also known as the "Greenspan put."

In many respects, this crisis was foreseen in advance. Almost every central bank which published a Financial Stability Review, and international financial institutions, such as the BIS and IMF, which did the same, had been pointing for some time prior to the middle of 2007 to a serious under-pricing of risk. This


The Goodhart analysis suggests that the subprime crisis would not have occurred if it had not been for very low interest rates, the Great Moderation, and the Greenspan put. But the crisis did occur and it centered on the subprime mortgage market. Perhaps that was because of a factor not discussed by Goodhart: the long period of steadily increasing US housing real estate values that led to a popular view that home prices would continue to appreciate and certainly would not fall. But prices did stop rising, and in fact fell with resulting widespread mortgage defaults. But since Goodhart’s three factors (minus arguably the Greenspan Put), as well as steadily rising home prices were, until recently, common in many countries and particularly in Europe, a comparative country analysis of financial regulation is justified. This comparative approach is particularly appropriate in view of the fact that some of the weak aspects of US practice—notably off-balance


6 The European Central Bank has a mandate focused on fighting inflation, whereas the Federal Reserve has, by statute, a dual mandate of fighting inflation while also promoting growth and employment, leading to different policies. This statutory mandate long preceded Greenspan’s tenure as Chairman of the Federal Reserve, and may be attributed to populist and/or political attitudes in the US Congress. As a result of its prime focus on inflation, the European Central Bank has, at least until quite recently, been less willing than the Federal Reserve to reduce interest rates in times of weak economic growth. On the other hand, there is good reason to believe that the Federal Reserve, which had lowered rates and increased the money supply to fight the short recession at the beginning of the decade, continued that policy for too long. See John B. Taylor, Getting Off Track: How Government Actions and Interventions Caused, Prolonged and Worsened the Financial Crisis 1–6 (Hoover Inst 2009).
Sheet vehicles such as structured investment vehicles (SIVs) and conduits—were also found elsewhere, particularly in German banking.

A factor that became increasingly obvious as the 2007 subprime crisis evolved into the 2008 credit crisis was the excessive leverage in the economies and particularly in the banks of the US and Europe. However, household leverage was greater in the US than in Europe, especially more than in Germany where household leverage has been relatively unpopular with most German families. Aggregate US household debt rose from approximately 50 percent of annual income in 1980 to roughly 100 percent in 2007.

This rise was associated not just with the housing boom and the refinancing of home mortgages to extract equity for personal consumption, but also with the popularity of credit cards as a way to boost personal consumption even for people without houses or other real estate. Data from the Organization for Economic Cooperation and Development (OECD) show that German personal savings rates have remained at or above the 10 percent level while US personal savings rates fell deeply into single digits in this past decade, and even beyond into negative territory on occasion.

In the financial sector, leverage was exploited more in Europe than in the US. European banks were leveraged to a far greater extent than US banks: “The dozen largest European banks have now on average an overall leverage ratio

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(shareholder equity to total assets) of 35, compared to less than 20 for the largest US banks. In 2007, the leverage ratio (defined as total assets to equity) was 63.9 for UBS, 54.5 for Deutsche Bank, and 52.7 for Barclays Bank. The extent of the leverage was not widely known at the time because regulatory authorities used measures such as "Tier 1 equity" and not the gross leverage measure of total assets to equity (that is, common stock only, not counting preferred stock or hybrid securities such as debt convertible into common stock). So, for example, Deutsche Bank’s gross leverage grew from under thirty to well over fifty between 2003 and 2009, while its Tier 1 regulatory measure remained essentially flat.

According to one important study, banks in Germany used leverage to a greater extent than banks in any of the other eleven financially most significant countries in the world.

The problem of high European bank leverage was compounded by the fact that more of the largest banks in the world were to be found in Europe than in the US. Similarly, both German banks and US banks made use of off-balance-sheet vehicles for their transactions in subprime mortgage securities. The combination of the use, not just in the US but also in Germany and Europe as a whole, of off-balance sheet vehicles and excessive leverages.

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Moreover, European banks have been far more exposed to borrowers in the emerging market countries than US banks\textsuperscript{11}, a fact that became important in the precipitate decline of many emerging market stock markets and exchange rates in October 2008, particularly in Eastern European countries that had been favorite lending and investment destinations for European financial institutions.

In order to illustrate parallels in the subprime crisis across countries, the structural and historical similarities between various financial institutions, using German and US banks as examples are compared and reviewed. Further discussion on the fragmentation problem as it exists in the US (because of the many regulatory entities) and in Europe (because of separate regulation in each country) and the concerns raised by the so-called “shadow banking system.” In the history behind the economic crisis and the securitization process itself to explain why bank regulation is necessary. Further investigations of the causes behind the regulatory failure, and recommendations, identifying specific areas for improvement.

\textbf{FINANCIAL INSTITUTIONS IN EUROPE AND THE UNITED STATES}

Finance in Europe remains, despite the efforts toward economic integration, a national industry from the standpoint of most European economic regulation, particularly bank supervision. As we shall see below, the role of the individual states in the US has diminished steadily, especially in the last half of the century.

\textsuperscript{11} The exposure of European banks to emerging markets is roughly ten times greater than the exposure of US banks. Institute of International Finance, Capital Markets Monitor 7 Chart 3 (Nov 2008).
The EU has been more concerned with enabling banks from one member state to penetrate lending and other financial markets in other member states than it has been in bringing about an integrated system of EU-wide bank supervision or even in creating uniform bank supervisory practices across the EU. Thus, it is appropriate to look at a specific country when analyzing solutions to the problems highlighted by the subprime crisis. Germany serves as an ideal country for that purpose. Germany has the largest financial markets in Europe, next to the UK.

Germany was more dramatically impacted by the subprime crisis than other European countries. And Germany was historically a pioneer in the development of real estate finance through the institution of the Pfandbrief, the original example of a covered bond.

A. Banks in Germany
When one thinks of financial services in Germany, one immediately thinks of the banks. In contrast, there have been, until recently, many large financial firms in the US that are not banks in the sense that they do not take consumer deposits. In the jargon of finance, they are not depository institutions. Goldman Sachs has been a world-famous example.

Within Germany, the banking system involves three types of institutions: commercial banks, savings banks (including the Landesbanken), and cooperative banks.
Only the commercial banks are privately owned in a strict sense. The fact that roughly half of bank deposits are not in truly private-sector institutions comparable to US private sector banks might suggest to an American observer that privatization of publicly owned banks would greatly improve efficiency and hence contribute to economic growth. But aside from the Postbank, there is very little movement toward privatization for the sensible reason that most non-private banks, especially the local savings banks, give good and low-cost service both to local depositors and to local borrowers. Still, the removal earlier in this decade of the state guarantee from the Landesbanken (as a result of an EU decision that the German guarantee was an unlawful state aid under the EU treaty) was potentially a step toward partial privatization. In any event, there are many fewer banks in Germany than in the US, even when adjusted for population.

B. Banks in the United States
The history of banking in the US is exceedingly complicated. At the beginning of the nineteenth century, the US had a dual banking system, in which both states and the national government could and did charter banks. However, each state could essentially decide what kind of banking structure it wanted in its state, even with respect to nationally chartered banks. Many states had quite restrictive branching rules. To take an extreme example, Illinois permitted no branches whatsoever. Each Illinois bank could have only one office. Eventually, through state and federal legislation, this preposterous imitation of small town America gave way to economic reality. Today, thanks to the 1994 Riegle-Neal Act...
Act\textsuperscript{14}, banks can merge and branch on a countrywide basis. This legislation put an end to most state protectionism in banking.

Consequently, the number of banks in the highly decentralized US system fell from over 14,000 to about 7,000 and continues to fall—though the increase in the number of bank branches has assured that bank buildings appear far more numerous than in the past. An interesting example of the change is that the Bank of America, a historically renowned San Francisco bank now headquartered in North Carolina, now employs more than 200,000 people as a result of mergers over the last decade and has become the largest US bank.

Another major difference between Germany and the US is that “universal banking” was not possible in the US until relatively recently. It is true that universal banking was common in the US prior to 1933, but it was then outlawed in the Glass-Steagall Act by Congress, which blamed universal banking for the Great Depression.

As a result, two separate financial services industries grew up: commercial banking for loans and investment banking for securities. However, the US gradually returned more or less to universal banking through a series of interpretations that allowed commercial banks to do more and more in the securities field and then through repeal of two provisions of the Glass-Steagall Act in the Gramm-Leach-Bliley Financial Services Modernization Act of 1999. Today Citibank is an enterprise organized as a “bank holding company” that owns not only a

huge commercial bank subsidiary but also another subsidiary that is one of the largest underwriters of securities in the US. And though most large bank enterprises are in the securities business, they have to separate their commercial banking business, which is entitled to accept deposits insured by the Federal Deposit Insurance Corporation (FDIC) and thereby enjoys what is often called "safety net" protection from their securities business. The technique used is to create a bank holding company, which owns a commercial bank subsidiary accepting insured deposits and one or more other subsidiaries engaged in other businesses, such as a subsidiary that underwrites and deals in securities. In the case of bank holding company insurance activities, the insurance subsidiary would be regulated by the insurance commissioner of the state where the insurance business is conducted. In fact, insurance as an industry can in general only be regulated by the states under existing law.

C. Banking regulation
Although under the US dual banking system, state-chartered banks are governed by state banking law, a state bank of any size will nevertheless be regulated by a national regulatory agency. The details are of interest only to banking lawyers, though they bear on an important characteristic—indeed, an important weakness—of US banking regulation: namely, a multiplicity of banking regulators and a resulting dispersion of authority. From a German and EU point of view, this "fragmentation" of US regulation has serious consequences for global financial governance.

1. Safety and Soundness Regulation
In the US the most important kind of regulation has to do with what Americans call “safety and soundness.” It is so called because it is designed to prevent banks from taking excessive risks, thereby harming depositors and the economy. A more internationally used term is capital adequacy regulation, and today it covers much the same ground as the Basel I and Basel II agreements. Banking regulation is often referred to by the term “banking supervision” to stress the close relationship and working arrangements between individual banks and their regulators. Some analysts make a distinction between regulation and supervision of banks to stress the difference between rules of general applicability and the discretionary roles of the regulating agency, particularly as it deals with individual banks. Indeed, in the US, the FDIC has the power to look in great detail at the internal records of a bank and to close the bank if it fails to take prompt corrective action to rectify certain regulatory violations.

1. Today the federal government of the US has five bank regulatory agencies, all performing similar functions, but with different kinds of banks
2. The Office of the Comptroller of the Currency (OCC) for nationally chartered banks.
3. The Federal Reserve (Fed) for state-chartered banks that are members of the Federal Reserve system. The Fed also regulates “bank holding companies,” a category of financial institutions that played a role in the crisis and in proposals for legislative change with respect to systemic risk.
4. The FDIC for state-chartered banks that are not members of the Fed system.
5. The Office of Thrift Supervision (OTS) for so-called “thrifts,” which used to be called savings and loan associations. Thrifts correspond more or less to
German Sparkassen, though in the US they are now privately owned. Not all thrifts, however, are small or local. Washington Mutual, the largest thrift, was the fifth largest bank in the country measured by deposits until it encountered problems in the subprime crisis. After the FDIC intervened (under its safety net powers) to put it in receivership, Washington Mutual was acquired by JP Morgan Chase¹⁶.

6. The National Credit Union Administration (NCUA) for credit unions, which are small local banks that usually service only employees of a single employer or members of a union.

In addition, there are firms usually not thought of as banks that offer checking accounts and money transfer services—for example, brokerage firms acting as agents for the purchase and sale of securities for their customers—and their regulation is entirely different. Then there are investment banks such as Goldman Sachs, which for large business customers are much like a bank, but are not usually thought of as a “bank” in the commercial banking sense of the word because they do not take consumer deposits. To the extent that brokerage firms and investment banks are subject to capital adequacy regulation at all, it is normally through the Financial Industry Regulatory Authority (FINRA) as overseen by the Securities and Exchange Commission (SEC) because of the firms’ and banks’ brokerage activities. But recent events, especially the 2008 “bailout” of Bear Stearns through actions of the Fed, have raised questions on whether any financial entity that enjoys even tacit guarantees from the US government should not be subject to some aspects of bank-like regulation.

In the home mortgage arena, there are a large number of firms that merely originate mortgage loans, often selling them to other financial institutions. Many of these mortgage companies are quite small, perhaps having only a single storefront in a small town or suburb, even on a neighborhood shopping street in a city. Their mortgage origination underwriting standards—sometimes rather low to say the least—have played a role in the present crisis. Putting aside questions of fraud by originators, which have figured prominently in the press, there is little doubt that underwriting standards declined greatly during the subprime period. For example, between 2001 and 2006, the average loan to value percentage on home mortgages rose from 79.8 percent to 89.1 percent, the share of mortgage loans that involved 100 percent financing rose from 3 percent to 33 percent, the share of limited documentation loans (so-called “liars’ loans”) rose from 27 percent to 44 percent. Yet non-bank mortgage companies are even now essentially unregulated.

Another set of companies, usually referred to as “government-sponsored enterprises” (GSEs), namely Fannie Mae and Freddie Mac, has played a huge role in the home mortgage field. In fact, well over half of all new securitized mortgages were guaranteed by these GSEs. In addition, GSEs held large volumes of home mortgages on their books for investment purposes. By March 2008, the GSEs had issued so much debt (counting guarantees) that their outstanding debt was roughly equal to the publicly held debt of the US in its governmental capacity. Especially relevant to the subprime crisis was the...
extraordinary shift in 2005 of GSE activity away from traditional conventional prime mortgages to a program of buying and guaranteeing subprime mortgages. By 2007, some one-third of the GSE’s business involved subprime mortgages. Moreover, between 2005 and 2007, the great majority of Freddie Mac’s mortgage activity involved mortgage loans that were quite different from traditional mortgage loans of the early days of the GSEs: “90 percent were interest-only mortgages [that is, no amortization of principal]; 72 percent were negative amortization loans [that is, interest was not paid but rather added to principal]; and 58 percent had original loan-to-value ratios greater than 90 percent.” Fannie Mae and Freddie Mac “ended up holding more than half of the AAA-rated subprime securitizations.”

The GSEs operated as corporations with private shareholders, but they long benefited from a number of special privileges that caused commentators to refer to them as having “tacit” guarantees from the US government leading to their ability to borrow at below commercial rates while lending at market rates. Legislation in the summer of 2008 considerably strengthened the GSEs’ regulator and changed its name to the Federal Housing and Finance Administration (FHFA). Finally, in September 2008 the federal government asserted direct control, through the FHFA, over the GSEs and effectively mooted the question of how the GSEs fit into the Federal regulatory complex.

The big five bank regulators—the OCC, the Fed, the FDIC, the OTS and the NCUA—are so-called independent agencies. The OCC, for example, may be in, or a part of, the Department of the Treasury, but that is a statement essentially about real estate. By legislation, the Secretary of the Treasury has no authority over the
CHAPTER VI: The Subprime Crisis & Financial Regulation - International and Comparative Perspectives 17

Comptroller’s policies and decisions. Coordination among these five bank regulators is normally at arms’ length and is entirely voluntary.

What’s wrong with this pluralistic and decentralized system, since decentralization of power is normally thought to be a good thing?

First, the decentralization of regulation exists only because the statutory mandate of each regulatory agency is different, the differences being mostly accidents of history. Second, each bank can choose its own regulator to expand its business and/or increase its profitability, just by switching from federal to state charter (or vice versa), by becoming a member of the Fed or dropping Fed membership, or through other relatively minor changes. This process, where the regulated party’s action changes which regulation applies, is often called “regulatory arbitrage.” Choice is often a good thing, and so may be “regulatory arbitrage.” But the motivations for regulatory arbitrage in bank regulation often have nothing to do with safety and soundness or even with competition. Rather, the motivation is achieving financial advantage by, for example, avoiding the fees by which the OCC must fund itself, and hence regulatory arbitrage may not make a positive contribution to regulatory policy. Safety and soundness regulation, with legions of bank examiners pouring over bank accounting documents, is expensive. The Fed and the FDIC, which have independent sources of funds, pick up the check for their own regulation of state banks. For example, the Fed spends (just on safety and soundness regulation alone) about one billion dollars a year of its own money,

18 Carnell, Macey, and Miller, The Law of Banking and Financial Institutions 61–62 (cited in note 40). Similarly, the OCC does not have to clear legislative proposals through the Office of Management and Budget, as would an agency that is clearly part of the Executive Branch. See id (observing that the OCC does not have to turn to congressional appropriations for funding because it can fund itself through fees from national banks); see also id at 61–64 (discussing generally the independence of the OCC, Fed, FDIC, OTS, and NCUA).
which it makes essentially by creating money as part of its monetary responsibilities. But the OCC, unlike the FDIC and the Fed, has no independent way of generating money, so it has to charge its banks, the national banks, assessments to help pay for the regulation\textsuperscript{19}. So the national banks had, at times, a powerful financial incentive to switch their charters to state charters, just to avoid the fee assessments. More recently, OCC regulation has become more popular with banks because of the frequency with which courts have held that national banking law preempts state laws with regard to certain operational issues involving national banks.

Similarly, some banks have changed from being regulated by the OCC to being regulated by the OTS. The objective of such banks appears to be to lighten the constraints on the banks' operations. The OTS has a reputation for being a more pliable regulator. In the case of IndyMac, a bank that failed in 2008, a report by the Treasury Inspector General indicates that an OTS official bent the rules to allow IndyMac to appear better capitalized than would have been the case under a more literal application of the applicable rules. Countrywide Financial, a leading firm promoting subprime mortgages and which later had to be saved by its acquisition by Bank of America, also switched to OTS, again apparently in search of more lenient regulation\textsuperscript{20}. Bailey, Elmendorf and Litan have criticized the idea of merging these regulatory agencies as changing boxes in a governmental organization chart rather than changing what happens in each. That


\textsuperscript{20} Daniel Hemel, How to Hold Bank Regulators Accountable, Forbes.com (Dec 18, 2008), online at http://www.forbes.com/2008/12/18/sec-fdic-regulation-oped-cx_dh_1218hемел_print.html (visited Nov 21, 2009) ("[I]n early 2007 Countrywide Financial Corp. re-chartered, ditched its old regulator (the Comptroller) and switched to a new regulator (the notoriously-lenient OTS).")
would be true if marrying those five organizations together were merely a marriage of convenience. But regulatory arbitrage is often a problem. It is worsened by the fact that each of the five regulators has its own private sector constituency and in turn, its own supporters within the legislative process, as vested private interests compete for favorable legislation. Regulatory arbitrage is particularly unfortunate where the jurisdiction of different regulators overlaps so that different regulatory agencies can exert authority over hybrid products, as is the case for derivative products subject to the jurisdiction of both the SEC and the Commodities Futures Trading Commission (CFTC).

Also, under the economic structure that has evolved in the last decade, a conglomerate banking institution can lend to borrowers from its commercial bank subsidiary, its investment banking subsidiary or its brokerage subsidiary. The regulation can be different for each part of the conglomerate bank. Moreover, these big complex conglomerate financial corporations engage not just in lending but also in other activities such as investment banking, merchant banking (including private equity), over-the-counter derivatives, asset management, and brokerage just like any European universal bank. Although the Fed has some statutory oversight responsibility over bank holding companies, no single agency can regulate, or even understand, the whole enterprise. The fact that a holding company may be required to create a subsidiary for a particular field deals with only some of the risks. Certainly, a regulatory agency that can deal with only one part of the enterprise cannot fully discharge its responsibilities.
2. Is there a better way to regulate?

Isn’t there a better way? The UK in 1997 moved to establish a single financial regulatory agency, the Financial Services Authority (FSA). The institution became a model for many other countries. In 2002, the Bundesanstalt für Finanzdienstleistungsarbeit (BaFin) became the single regulator for banking, securities and insurance in Germany. The FSA model contrasts with a “twin peaks” model of regulation, which organizes regulators by the purpose of the regulation, placing prudential regulation in a different agency from business conduct regulation. But both the FSA model and the “twin peaks” model are paragons of simplicity compared with the complexity of the US regulatory model.

The FSA model provides a single regulator for banks and other deposit-taking institutions. But perhaps even more important, the FSA model regulates the issuance of securities (which is done by a separate agency in the US, the SEC). The FSA model also regulates derivatives, which in the US is done by still another agency, the CFTC, so named because it got its start regulating futures contracts for agricultural commodities. In contrast to the UK, Germany, and many other countries that have adopted the FSA model, the US (with its five banking agencies, an SEC and a CFTC) has a dysfunctional regulatory structure. The current crisis in the securitization of mortgages, since it involves both banking and securities, has exposed to public attention the weaknesses of such a fragmented structure.

In the US, banking regulatory agencies are not involved in the enforcement of the securities laws, but the fact that securitization involves both loans and securities suggests that it may be advantageous for the US to consolidate the regulation of the two areas, following the example of the British FSA, the German BaFin, and similar consolidated agencies in other countries. Since the various US regulatory agencies are "independent" and not required to take direction from the US Treasury, the Treasury has awakened to the fact that when everyone is in control of some small piece of a problem, nobody is really in control of the entire problem. The US Treasury announced in the autumn of 2007 that it would undertake a review of the US regulatory structure and, in the words of a Treasury Undersecretary, the review would take into account all financial services industry participants including insurance, securities, and futures firms, in addition to depository institutions, upon which most past Treasury Department studies have focused. That review was accelerated in view of the worldwide financial crisis, and in March 2008, the Treasury released a 218-page "Blueprint" for regulatory reorganization. Despite the ambition of the Treasury Blueprint, there are historical grounds for doubting whether such a consolidation will ever occur. President Clinton’s first Secretary of the Treasury, Lloyd Bentsen, a former Senator and hence supposedly an expert on legislative politics, tried to convince President Clinton to endorse such a consolidation. But nobody listened. President George W. Bush’s first Secretary of the Treasury, Paul O’Neill, also proposed such a consolidation, but the White House told him that it was politically impossible. Even if a reorganization of the scope proposed in the Bush Treasury

Blueprint were eventually adopted, the Blueprint’s release during an election year made action unlikely until a new administration had time to review the recommendations and both houses of Congress had time to hold extensive hearings. Such hearings, in view of the extent to which powerful interest groups could be expected to oppose certain aspects of the legislation and to push their own complicating add-on proposals, would always be contentious and lead to public controversy24.

Change in US government organization rarely happens except in the wake of a scandal (or other extraordinary circumstances), but the subprime crisis—especially with the follow-on credit crisis—certainly rises to that standard. Most of the current bank regulatory agencies listed above were created because of extraordinary circumstances. The OCC was created in the 1860s because of the financial difficulties of subduing the South in the Civil War. The FDIC was created at the time of widespread bank failures in the Great Depression. And one could add other historical events driving regulatory changes.

Even in the unlikely event that consolidation occurs, there are historical reasons for doubting the quality of the results. For a recent example, the creation of the Department of Homeland Security in the wake of the terrorist attacks of September 11, 2001 has hardly brought a major improvement in the government’s capacity to deal with terrorism in the US. The tough problem of terrorism aside, a financial regulatory consolidation faces obstacles. The regulatory agencies themselves include many people who will resist—for well-known bureaucratic reasons. And the companies being regulated will find self-serving reasons for

24 For suggestions as to how a consolidation of banking regulatory agencies might be undertaken, consider id.
keeping the present decentralized system. Finally, members of Congress seem far more interested in posturing as protectors of millions of defaulting homeowners than in trying to work on more systemic financial system problems.

Of course, reorganization does not guarantee improved results, and this is particularly the case when the subject matter goes beyond regulation. For a recent and highly relevant example, the British FSA, together with the British Treasury and the Bank of England, faced major problems in coordinating a response among themselves in connection with the Northern Rock bank collapse in the summer of 2007. In the end, Northern Rock had to be nationalized. More generally, the role of the central bank in regulating banks vis-à-vis the role of an agency with more specific statutory responsibility for bank regulation raises difficult and complex "fragmentation" questions in many European countries. But even the FSA itself later admitted that it performed poorly in its own supervisory role with respect to Northern Rock.25

In any event, there is little or no support in the US, even within the US Treasury, for doing what the FSA model presupposes, namely, bring banking, securities and insurance regulation into a single agency. Certainly, the Treasury in both the Bush and Obama administrations has assumed that each of these three financial sectors would continue to be separately regulated. Under the Bush administration Treasury Blueprint, the regulation of securities would have been consolidated with the regulation of derivatives. And under the Blueprint, insurance would have continued to be regulated separately by the fifty states, though an optional

A national charter would be created, which many large insurance companies would presumably choose to adopt if the national charter would include significant preemption of state regulation. Furthermore, under the Bush administration position, banking regulation would be consolidated in one agency subject to a residual role for the Fed over bank holding companies.

The Obama Treasury has been even more modest. Its June 2009 proposal, while decrying regulatory fragmentation, proposed simply consolidating the OTS and the OCC, leaving federal regulation of state banks with the FDIC and the Fed. Indeed, Scott has argued that the Obama Treasury proposal actually makes fragmentation worse by creating four additional agencies to deal with the financial meltdown that followed the subprime phase of the crisis and by “doing away with federal preemption for national banks and failing to endorse the optional federal charter proposal for insurance companies.”

The Treasury's modesty with regard to overall consolidation of financial regulation reflects political reality in view of the long history of the US federal structure. The Bush Treasury insurance is a single industry today, unlike the situation decades ago when there were many local insurance companies and insurance cooperatives.

So eventually, the absurdity of fifty states regulating companies operating nationwide, indeed worldwide, may perhaps give way to reason. The need for a federal bailout of American International Group (AIG), one of the world’s largest insurance enterprises, in which $85 billion was made available to AIG by the Fed in a revolving credit facility and the US Treasury took just under 80 percent of the shareholder voting power, raises serious questions about state-only insurance regulation. That is particularly the case because the crisis leading to the bailout was AIG’s massive solvency-threatenning issuance of credit default
swaps, a form of derivative that is not even insurance in the strict legal sense. In any event, fifty-state regulation means de facto regulation by the state of New York, which is the site of the headquarters of many of the large insurance companies. Only New York seems to have the capacity and the interest to do a serious regulatory job.

3. European Fragmentation

The EU suffers from a different kind of fragmentation. The regulation of new instruments like subprime securities and of securitization generally is a question for the member states, and the European Central Bank has little to say about regulatory, as opposed to monetary, issues. The European Central Bank is a creature of the Eurozone, the area of the EU in which the Euro is the currency. A substantial number of EU countries still use their own national currencies, mainly in the newer eastern European members, but the most important financial capital in the EU itself is London, which is not in the Eurozone and therefore has the British pound as a home currency. The EU rarely concerned itself with bank regulation except insofar as such regulation might interfere with a major EU goal—the increase of cross-border banking as a way of speeding the Blueprint did not eliminate state chartering of banks, and it clearly contemplated some continued state consumer protection legislation of banks. Yet creation of a single European financial market. The EU had not, until very recently, been involved in financial stability issues. In the US, in contrast to the EU, there is some limited regulation of state banks by state agencies, but all important and systemic issues concerning banking (as opposed to insurance) are questions for federal regulators.
The issue of a Eurozone-wide single financial regulator surfaces from time to time. An early French proposal for an EU-wide regulator was resoundingly rejected. But the large bank losses stemming from the subprime crisis and the failure of Northern Rock in the UK stimulated interest in supplementing the European Central Bank monetary policy authority over the Eurozone with some kind of corresponding competence in financial regulation. To achieve that end, it was necessary to use the EU, in view of the lack of competence of the European Central Bank to exercise jurisdiction outside the Eurozone.

A report to the European authorities in Brussels by Jacques de Larosiere, chair of an EU High Level Group, helped galvanize attention toward the cause. The EU Commission subsequently built on an existing set of EU “third level” coordinating committees in the member states to create a program for enhancing and harmonizing EU member state banking regulation. The Commission created a structure for doing so, but it remains to be seen whether this structure will be effective enough to overcome European fragmentation.

4. The Shadow Banking System

The Treasury Blueprint’s proposal to merge banking regulators obscured part of the complex reality that came into view during the subprime crisis and the ensuing credit crisis. First, not all of the institutions that lend or otherwise provide capital are banks. The additional non-depositary institutions, which journalists sometimes collectively call the “shadow banking system,” include broker-dealers, hedge funds and private equity firms. None of them was regulated as a bank,
though in 2008 most remaining large broker-dealers that engaged in investment banking activities chose to become bank holding companies regulated under the Fed in order to be able to qualify for financial assistance on much the same basis as commercial banks. In addition, the “shadow banking system” included unregulated legal entities created as part of the securitization process, notably structured investment vehicles (SIVs). SIV assets were frequently absorbed back into the banking system by sponsoring banks because of the reputation risk to those banks of not standing behind those vehicles. Far from being a mere tail on the formal banking system, these “off-balance sheet vehicles” were a huge proportion of the overall financial system. “By 2007 the New York Fed calculated that the combined assets of all the SIVs and similar vehicles came to $2.2 trillion, while hedge funds controlled another $1.8 trillion, and the five [largest investment banks] had $4 trillion on their balance sheets . . . [whereas] banks as a whole had $10 trillion in assets.”

At the other end of the subprime mortgage securities assembly line were the mortgage brokers that played a crucial role in creating the subprime crisis by selling mortgage loans to home borrowers who could not qualify for prime borrower status. In many cases, these borrowers did not have sufficient income to make their mortgage payments, even at the time they borrowed and certainly not later as the economy softened. As time has passed, the view has gradually become more dominant that mortgage lending practices were most at fault for producing the subprime mortgage crisis and therefore most in need of some kind of regulation, albeit not necessarily by banking regulators. Thus, even though the Treasury Blueprint was regarded by many observers as impossibly ambitious at the time of its release in early 2007, it can be seen as perhaps not ambitious enough to deal with the subprime crisis and the ensuing credit crisis, particularly at
the initial lender-borrower end of the securitization chain where the initial
dividual mortgage loan transaction occurs. These transactions, especially for
subprime loans, are largely unregulated and too often characterized by borrower
ignorance and lender deception as to terms and conditions. It is for this reason that
the Obama administration proposed the creation of a Consumer Financial
Protection Agency (CFPA). The CFPA proposal has been harshly criticized, to
take the language of one critic, as reflecting “elitist protection concerns that
consumers don’t need.” But the proposal has also been supported in principle on
the straightforward ground that these local transactions can be made fairer and
more efficient for the national economy if better and simpler information for
consumers is mandated as part of each transaction.

THE ROLE AND CHALLENGES OF REGULATION:

WHY REGULATE BANKS AT ALL?

One of the fears raised by the fierce public reaction to the present international
financial crisis is that any new regulation introduced will do more harm than good.
In order to assess proposals for change, it is therefore useful to consider the
reasons that have led all countries to regulate banks. The regulation of banks has
many objectives. Aside from concerns about fraud and consumer protection, the
principal justification for regulation of the banking sector involves the confluence
of a few main factors.

First, a healthy financial sector is crucial to the stability and growth of the entire
economy of a country.
Second, the banking part of the financial sector is peculiarly prone to crises. Every decade the banking sector experiences a crisis in one or more major countries. In the past quarter century we have seen the savings and loan crisis in the US, the Asian financial crisis, and the long-lasting Japanese non-performing loan problem, as well as severe country-specific crises in Sweden (1991), Finland (1991), and Norway (1987) and lesser financial crises in Australia (1989), Canada (1983), Denmark (1987), Greece (1991), Iceland (1985), Italy (1990), New Zealand (1987), and the UK (1991). By 2009, the world’s financial headlines were filled with the worldwide ramifications of the subprime mortgage crisis, which had rapidly turned into a worldwide financial crisis because so many financial institutions in so many countries had invested in securities that were simply packages of US subprime home mortgage loans.

A third factor, having to do with the operations of banks, is that banks are thinly capitalized compared to other kinds of corporations. Specifically, banks are particularly highly leveraged compared to many types of financial institutions, although normally less so than many hedge funds.

Fourth, banking profitability tends to depend on borrowing short and lending long. Clearly, this strategy enhances profitability, since in normal times the interest rate curve slopes upward, with short-term rates being lower than long-term rates. But sometimes the curve is flat or even inverted, and then banks face financial difficulties. In economic downturns, the default rate of bank borrowers rises. As a result, lending banks, as they become perceived as riskier, may face rising funding costs in their short-term borrowing.
This fourth factor goes to the heart of the special economic nature of banking. Thin capitalization and a "borrow-short, lend-long strategy," seem necessary for a bank's profitability, or at least it was necessary when banks depended on interest payments on their loan portfolio, as opposed to fee income for various financial services. In order to assure that banks did not become insolvent and hence default on their obligations to their depositors, capital adequacy became a principal form of bank regulation. Capital had to be adequate to assure that a bank could pay off its creditors—principally its consumer depositors—at all times. And since government deposit insurance often involves a separate fund (such as that maintained in the US by the FDIC), regulators have a special, separate incentive to protect that fund through capital adequacy requirements.

A further purpose of bank regulation is to prevent financial instability. Financial instability means the collapse or weakness of one bank leading to the collapse or weakness of other banks—in short, systemic failure of the banking system. From the standpoint of the world economy, the purpose of international agreement on capital adequacy regulation is not so much to protect the creditors of a particular bank or to protect the banking system of any particular country but to prevent a bank failure from leading to failures of many banks and hence to financial instability across countries. Various popular terms are used to describe the instability problem that capital adequacy regulation addresses. Americans talk about the domino effect. The British call it "knock-on" effects. Whatever one calls it, a normal goal of bank regulators is to reduce these collective effects. This regulatory goal is often called the objective of financial stability.
A. The Subprime Issue in Europe

The subprime crisis led to severe effects in a number of countries. A leading illustration involves effects on banks in Germany. The spread of the subprime mortgage problem from the US to Germany is a good illustration of the domino effect in which financial instability can spread not just from one bank to another but from one country to another.

Though the problem originated in the US, the resulting weakness and even failure in Germany of several Landesbanken (masked, to be sure, in part by forced mergers of Landesbanken), the quadruple bailout of IKB (a leading lender to mid-sized, or "Mittelstand" industry), and the big losses of private sector banks—even Deutsche Bank, which initially appeared to have avoided the exposure to subprime mortgages—have captured public attention. These events illustrate that in the present globalized financial world, worldwide financial stability must be a cooperative effort by national regulatory bodies, involving both buyers and sellers of securitized products. German banks bought the subprime mortgage securities apparently without knowing, or perhaps without caring, exactly what they were buying. They did so because the prospective returns were relatively high compared with their other investment opportunities.

The Sachsen Landesbank, which later had to be merged with another Landesbank, went so far as to create a special unit in Dublin to carry out trading in subprime mortgage securities. Moreover, it is useful, in considering recommendations concerning off-balance sheet entities such as SIVs and conduits, to consider that such entities have been used by investing banks, and not just by originating and
securitizing banks. As C.A.E. Goodhart has pointed out:

German landesbanken, IKB and Sachsen . . . had conduits . . . [that] were many times the size of their own available capital stock. With the decline of the value of assets in their conduits, in effect these landesbanken were suffering a severe reduction in their own capital, and they had to be . . . bail[ed out] by their respective regional governments.

In fact, the Sachsen Landesbank had conduits with assets equal to 30 percent of its total assets and hence, as a typically leveraged bank, many times its capital. Similarly, IKB’s “conduit- and SIV-financed assets” were equal to nearly five times their equity and over 20 percent of their on-balance sheet assets, and hence when they could no longer roll over the short-term financing of those off-balance sheet items in the commercial paper market, IKB had to meet its “contractual obligation” to finance these assets, much of which were presumably subprime mortgage-backed securities. By March 2008, the estimated rescue costs mounted to almost €8 billion, exceeding the bank’s equity about fivefold.

Moreover, in the case of IKB, it was not American banks or their off-balance sheet vehicles that sold subprime securities to IKB, but rather Deutsche Bank, Germany’s largest privately owned bank. IKB bought the subprime securities through its own special purpose vehicle, Rhineland Funding, which was able to fund itself in short-term money markets in part thanks to credit guarantees provided by Deutsche Bank.
Although Rhineland Funding was IKB’s special purpose vehicle, Deutsche Bank provided the administrative services for Rhineland Funding, including acting as custodian and trustee. This German example illustrates the more general phenomenon that at least some European banks seized the opportunity to sell subprime securities backed by US mortgage loans and that European financial institutions used SIVs and conduits in much the same manner as American financial institutions. Thus, it would be wrong to assume that regulatory reform is primarily about changes required in US law or that these changes would affect operations of only US banks. The use of off-balance sheet entities should be regarded not just as a securitization problem, but a worldwide banking regulation issue.

Subprime problems in Europe arose heavily from the purchase of US-origin securitized mortgage loan products, but a substantial proportion of European problems arose from the use by German banks of the same originate-to-distribute securitization as practiced in the US. Although Germany largely escaped these kinds of problems by use of covered bonds, as described above, the UK, Spain and the Netherlands suffered substantially from the sale of securitized mortgage products. According to a European Central Bank study, securitization was little used in Europe prior to the adoption of the euro as the common currency of the Eurozone, but thereafter there was a “spectacular increase in securitisisation activity in the euro area.” Nevertheless, though securitization has been used in Germany for German residential real estate financing, the specific types of problems plaguing the US with regard to subprime mortgages apparently have not arisen in the case of German real estate because of the special type of securitization utilized—the Pfandbrief, referred to in the United States as a covered bond.
B. The Securitization Process And the Subprime Crisis

Let us look in greater detail at what these securitized transactions were. Once upon a time, banks lent money to homebuyers, and the banks took mortgages as collateral for the loans. The banks then held these mortgage-backed loans to maturity, making their profit on the interest payments. Today US banks find that method of operation too old-fashioned. What they want is fee income, and they want it up front rather than spread over many years. By fees, I simply mean charges of any kind as opposed to interest income. In lending with houses as security, US banks often make (or buy) a large number of such mortgage loans, and then package them together in securities, using the underlying packaged mortgages as collateral for these securities. The securities are appropriately called mortgage-backed securities (MBSs). The process of securitization results in the bank being able to charge a fee for securitization (or sell the securities for more than the amount of the underlying principal of the mortgage loans), and thus translate long-term interest income into immediate income. Thus, income is accelerated and, more importantly, no reserves need be held under capital adequacy regulation, including Basel I. Even the newer Basel II does not automatically lead to higher required bank reserves. Although it would be too simple to say that Basel I led to securitization, there is little doubt that Basel I made securitization more attractive. Securitization helped to avoid Basel I capital adequacy requirements, most simply because as soon as assets are securitized, no assets remain on the balance sheet of the originating banks. According to one assessment, “securitization has rendered the 1988 [Basel] Accord’s minimum capital requirements ineffective as a tool to maintain adequate regulatory capital against the real risk taken.”
This new strategy of banks, particularly US banks, is known as the “originate to distribute” model, as distinguished from the old-fashioned “originate to hold” model. The term “subprime” has been defined in various ways, but in its broader meaning with regard to mortgages it refers to mortgages of less than investment grade.

When one turns to securitization, however, the use of tranches creates a new framework for the usage of the term “subprime.” The securities are sold in tranches. The highest tranche is normally rated AAA, the highest rating, but lower tranches have lesser and lesser ratings, let us say AA, A, BBB, and so on with some of such letter ratings being defined as prime and lower ones as subprime. The rating received by individual tranches has little and sometimes nothing to do with the quality and safety of the mortgages underlying the issuance as a whole. It is important to note that there is just one pool backing the issuance as a whole rather than a separate pool for each tranche. Indeed, through the alchemy of structure that has often been referred to as a collateral debt obligation (CDO), a tranche of securities may be rated AAA even though none of the underlying mortgage loans are of prime grade.

The AAA-outcome depends on the concept of credit enhancement. In addition to guarantees from monoline insurers, a principal way of achieving this enhancement is to use the loans in lower tranches as security.

This is through application of the “waterfall” principle of CDOs. All of the
interest receipts for all of the tranches are collected, and then are transferred to
the highest tranche investors first to the extent needed to satisfy their
contractual claims to principal and interest. Only when all of the highest tranche
investors are paid is any of the interest income received on behalf of the next
highest tranche. This procedure is then followed on down the tranches—hence,
the analogy to waterfalls. The middle tranches are commonly called “mezzanine
tranches” and the lowest tranches “equity tranches,” the latter by analogy to
equity investors who receive dividends only when all creditors’ claims are
satisfied.

Beyond the use of lower tranches as security for higher tranches, the principal
tools for according a large percentage of an offering an AAA
rating were: (1) overcollateralization, where the face value of the mortgages loans
backing a security add up to more, sometimes considerably more, than the face
value of the securities; (2) insurance, usually offered by so-called monoline
insurers whose business primarily involves insuring securities; and (3) the credit
rating process itself.

The securities created in this securitization process were sold not just in the US but
throughout the world. And many of the investors were banks. According to press
reports, the Bank of China held nine billion dollars’ worth of securities backed by
US subprime mortgages when the crisis erupted in the summer of 2007.

The resulting securities were especially hard for purchasers to evaluate, hence the
tendency to rely on credit rating agencies—one reason that the securities were
much more complex than the “plain vanilla” securities described above.
Some of the tranches from one mortgage pool were combined with tranches from other mortgage pools, resulting in Collateralized Mortgage Obligations (CMO). Other tranches were combined with tranches from completely different types of pools, based on commercial mortgages, auto loans, student loans, credit card receivables, small business loans, and even corporate loans that had been combined into Collateralized Loan Obligations (CLO). The result was a highly heterogeneous mixture of debt securities called Collateralized Debt Obligations (CDO). The tranches of the CDOs could then be combined with other CDOs, resulting in CDO2. ["CDO squared"]

Each time these tranches were mixed together with other tranches in a new pool, the securities became more complex. Assume a hypothetical CDO2 held 100 CLOs, each holding 250 corporate loans -- then we would need information on 25,000 underlying loans to determine the value of the security. But assume the CDO2 held 100 CDOs each holding 100 RMBS comprising a mere 2,000 mortgages—the number now rises to 20 million!

As a strategy, the securitization of mortgage loans can be quite profitable, but it is vulnerable to crisis, especially because institutional purchasers of the securities borrow to finance the purchase (using the increased leverage to increase yield from the investment). At least three generic mishaps can occur: the costs of borrowing can go up, access to borrowing can dry up, or the assets bought with borrowed money can fall in value. Since these three occurrences all happened in this crisis, the capital adequacy approach enshrined in Basel I and carried over, with modifications, into Basel II needs to be reexamined.
Quite aside from any imperfections in Basel I and II, the capital adequacy approach to bank regulation cannot deal adequately with the problem. First, on the originating side, it is important to observe that many, if not most, of the institutions that make the mortgage loans are not banks in the regulatory sense and are not subject to bank regulation. Rather, a great many are mortgage companies (usually referred to as mortgage brokers) that originate mortgage loans but usually do not hold mortgages to maturity. In the past, especially beginning in the 1980s, these mortgage brokers originated the mortgage loans and sold them to GSEs, which packaged them in MBSs, which were then sold to investors. Later many commercial and investment banks chose to take on a securitizing role. These securitized offerings began to be referred to as private label MBSs to differentiate them from GSE-securitized offerings. An advantage to the banks through securitization was that as soon as the mortgage loans were securitized and the securities were sold, there was nothing left on the banks' books and so there was nothing to which capital adequacy regulation would apply; and yet the bank had made money on the transaction.

Nonetheless, capital adequacy regulation applies to banks that buy MBSs. The buying banks obviously are subject to bank regulation, and many other buyers, such as insurance companies, are also regulated. Under capital adequacy regulation, whether or not of the kind found in Basel I and II, capital would need to be maintained with respect to such purchased assets. However, the buying banks could place these securities off the balance sheet in SIVs. Alternatively, buying banks could buy directly from SIVs sponsored by the originating bank. Most banking authorities did not attempt to exercise jurisdiction directly over SIVs, on the theory that the SIVs were not banks (even though they were bank-
sponsored) and the securities were just investments by a non-bank.

The SIVs, in the minds of the banks, were primarily a funding vehicle. The SIVs issued commercial paper sold directly to institutional investors such as money market funds. The SIVs used the proceeds of the commercial paper (and sometimes junior notes) in order to buy US-origin MBSs. In order to sell the commercial paper at a reasonable price, the SIVs pledged the MBSs they were in the process of purchasing as collateral for the commercial paper they were selling to pay for those securities. This SIV-issued commercial paper was therefore referred to as asset-backed commercial paper or, more precisely, mortgage-backed commercial paper.

Numerous reports by the IMF, the FDIC, and other bodies raised warning flags in the spring of 2007. Despite the regulatory concern, no public worries were yet evident about the ballooning volume of purchases by banks and other institutions throughout the world of securitized products that included subprime mortgages. Worries did not arise publicly until, suddenly, some purchasers of the mortgage-backed commercial paper from the SIVs refused to roll over the commercial paper. They were concerned about buying the commercial paper from faceless SIVs in view of the growing doubts of informed observers about the value of the collateral. To the extent the collateral for the commercial paper consisted of securities based on mortgages, the commercial paper became regarded as less than safe, however high the rating accorded by the rating agencies. The rating agencies had issued their ratings based on whether interest and principal on the MBSs would be paid when due. In issuing their ratings, these agencies were not offering a judgment on whether the SIVs would be able to roll over the short-term
commercial paper with which they financed their holdings while seeking to sell those holdings to ultimate investors. Once the commercial paper market began to refuse to roll the commercial paper over, the SIVs had no alternative but to sell at whatever price available the MBSs they had bought with the expiring commercial paper. Since the SIVs were simply vehicles without their own resources, continuing to hold the securities was not a realistic option. The result of those sales was that as the commercial paper markets began to seize up, the prices of even highly rated MBSs began to plunge. A cycle followed in which the process fed on itself. Investing banks and other institutions had to announce write-offs of their existing holdings of MBSs under accounting rules that required them to “mark to market” their securities.

The result was the full-blown crisis that first erupted in the summer of 2007 and which continued for many months. The press tended to focus on problems of various institutions that had invested in large amounts of MBSs distributed through the securitization process. But more bad news was to come. Some of the originating banks (not just investing institutions) began to experience problems. Some of those originating banks had undertaken to take back securities that had fallen significantly in ratings or values. Other originating banks had undertaken (as a “liquidity facility”) to provide their SIVs (or other intermediary purchasers) with additional funds when commercial paper financing became unavailable. Others took the securities back for reputational reasons: they wanted to be seen as standing behind their deals. Many banks were both issuers of MBSs and also investors in such securities. Indeed, many were forced investors simply because they were “warehousing” the securities. Increasingly, banks were forced to warehouse MBSs simply because they were hard to sell when market demand
became surfeited and ultimate buyers were plagued by emerging doubts. When banks found it necessary to reduce their warehoused inventory, the result was that market prices began to fall. The process quickly turned into a crisis—the subprime crisis—that became front-page news.

A SUMMARY OF THE CAUSES BEHIND THE REGULATORY FAILURE

In the US, the 2008 presidential election was deeply affected by political attitudes toward the housing market and the role of financial institutions in financing that market. As the result of competition for votes, most of the public attention was paid to the plight of the homeowners who were losing their homes. But throughout the world and in the US, regulatory officials, scholars and financial experts have continued to question what should be done in financial regulation in the downstream markets for mortgage loans securities. One regulatory issue involved the rating agencies (especially Moody’s, Standard and Poor’s, and Fitch) that had given AAA ratings to the top tranches of the securitizations. Another involved the application of capital adequacy rules to various aspects of the securitization process. There are many other specific regulatory issues, the most important of which are discussed in the remainder of analysis.

The initial problem with the securities was, however, not regarded as a rating agency problem nor as a capital adequacy problem, but rather as a liquidity problem in credit markets. Capital adequacy regulations and the Basel agreements have little to say on the subject of liquidity. Of course, market risk is considered in Basel II. And to the extent that Basel II deals with risk management
within banks, it also appears to deal with these kinds of problems. But a fair assessment of the problems indicates that bank regulatory agencies had taken a narrow view of their responsibilities—narrow at least given the state of globalization and financial engineering. The financial engineering involved in mortgage securitization was initially praised when it was seen as diversifying risks away from mortgage lenders. The problem was that hardly any regulators apparently knew, or perhaps even worried about to whom the risks actually were diversified. Nor did regulators at first consider whether some or all of the risk was actually retained de facto through liquidity commitments to sponsored SIVs or because of the securitizing bank’s need to provide liquidity to the off-balance sheet SIVs in order to protect the bank’s commercial reputation. Indeed, originating banks, in their rush to book higher and higher bank revenues, ignored the possibility that their financial engineering (that is, the practice of securitizing mortgages into SIVs or other off-balance sheet entities) would lead to losses in the long run.

In view of the decentralization of international financial regulation to individual countries, it is fair to say that US regulators were not particularly worried about non-US purchasers of the securities. Indeed, they probably had no jurisdiction to investigate foreign purchasers’ behavior. If the securities themselves were a problem, they apparently raised no securities regulation issues for the SEC in the US or in other countries where the securities were sold. And, of course, when the commercial paper market froze up, the Fed had no choice but to throw money at the problem by providing more liquidity to money markets and to move to head off any resulting recession by driving interest rates lower (while subordinating concerns about future inflation).