Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Systemic Risk: Can Legislation Prevent It?*

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One of the principal rationales for the financial reform legislation currently pending in Congress is the need to prevent the buildup of systemic risk in our financial system. This concern is not new. Systemic risk in the financial sector has been a fact of life since the development of our modern system of banking. Congress has repeatedly enacted legislation with the goal of eradicating systemic risk, typically by providing regulatory agencies with ever increasing prudential authority and imposing limits on activities and investments.

For example, following the financial crisis caused by excessive lending to less developed countries in the late 1970s ("LDC Debt Crisis"), Congress passed legislation "to assure that the economic health and stability of the United States and the other actions of the world shall not be adversely affected or threatened in the future by imprudent lending practices or inadequate supervision."[1]

Following the massive failures in the savings and loan industry in the mid-1980s, the Administration proposed, and Congress passed, the Financial Institution Reform, Recovery and Enforcement Act (FIRREA) under the banner of "Never Again."[2] Only two years later, in 1991, Congress again was faced with a systemic crisis in the banking sector, and the legislative response was, once again, prescriptive legislation to "assure the stability of our financial system," with the promise that the bill would eliminate the 'too big to fail' problem.[3] Why is it that these measures, which granted the Federal banking agencies almost unlimited supervisory powers, were unsuccessful in tackling the problem of systemic risk?

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*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] Public Law 98-181 (1983).

[2] The expression "Never Again" became the shorthand expression associated with the FIRREA legislation after that term was used by Secretary Brady in describing the Administration's proposal in hearings before the House Banking Committee in 1989.

[3] House Rep. No. 102-157, 102nd Cong. 1st Sess. at 118.

What is Systemic Risk?

Almost everyone agrees that systemic risk relates to the fact that financial institutions are interconnected, and that the failure of a single institution could result in the failure of many other institutions due to these interconnections.

The interconnections cannot be eliminated. It is the purpose of financial institutions to act as intermediaries transferring capital from investors (including depositors) to those in need of financial resources. This transfer of funds from investors to end users creates an interconnection among financial companies.

Further, financial companies are linked to other financial companies in many ways. For example, banks borrow funds from each other in order to meet reserve or other requirements, and banks may place excess cash with other banks in the form of short term deposits.

The systemic risk comes into play because if a financial institution fails, the consequences can spread among all of the interconnected companies, potentially resulting in multiple failures or even a regional or national recession.

Congressional Attempts to Prevent Systemic Risk

As noted, prior attempts at containing systemic risk have focused on enhancing regulatory authority over banks and other financial companies. For example, under legislation enacted in the past 27 years, the Federal banking agencies were given extremely broad authority to supervise depository institutions and establish safety and soundness regulations. This supervisory and regulatory authority was not reduced under the "deregulatory" measures enacted beginning in 1980, which were concerned primarily with geographic and product restrictions.

Under current law, the Federal banking agencies have the ability to prohibit any activity that is deemed unsafe or unsound. The agencies can order any bank, bank holding company, or financial holding company to divest a subsidiary or affiliate, or order such a company to take any corrective action the agency prescribes. The agencies have plenary authority to require a bank or financial holding company to increase capital levels, or can issue regulations mandating higher levels for the entire industry. The agencies can take an enforcement action for the violation of any law, Federal or state, or for the violation of any regulation. The regulators can assess civil money penalties that can be over a $1 million per day against individuals or companies. The SEC has also been given significant new powers, and public companies are now subject to extensive new requirements designed to assure compliance with all laws and regulations, and to maintain adequate internal controls. Yet, in spite of all of these provisions, the country suffered one of the most serious systemic failures in its history. Why was it that all of these laws proved so inadequate?

The Nature of Economic Bubbles

The most recent economic problems were not caused by a failure of banks or other financial companies to comply with prudential standards or regulatory direction. In fact, if anything, prudential regulations and the regulators encouraged financial companies to purchase and hold highly rated mortgage-backed securities, since these were viewed as very safe investments. While this turned out to be a mistake, this mistake was not caused by lack of prudential standards or regulatory oversight.

The problem arose because we were in the midst of a "bubble" in housing prices. In hindsight, it is clear that the price of homes increased beyond reasonable or sustainable levels. However, in the midst of the bubble, the conventional wisdom was that housing prices would increase, and that in any event decline in housing prices would be local and not national in scope. Naysayers were dismissed with the adage "prices may go down in another area, but in my state things are different." And because so many people thought that the price of homes can only go up, money flowed to the housing market, and with it came unsavory characters and unsavory practices. The reason that predatory lenders could operate and unscrupulous mortgages could be made was because investors were willing to fund those loans; and the only reason that investors risked their funds on these loans was the belief that if the borrower ran into trouble, the home could be sold at a profit.

What would have happened if the regulators ordered depository institutions to stop buying mortgage backed securities in the mid-2000s? No doubt there would have been expressions of outrage by affected industries: real estate developers, mortgage bankers, real estate brokers and agents, title companies, low-income housing groups, the construction industry, the furniture industry, real estate attorneys, to name a few. The argument would have been echoed by the Congress, which viewed the increase in housing prices as an engine for economic growth as well as a boon for state and local governments dependent on property taxes.

This is not speculation. As late as 2008, when some would argue that the downturn in the housing market and problems with "innovative" mortgages should have been clear to all, Congress passed legislation stating that Fannie Mae and Freddie Mac must "provide leadership to the market in developing loan products and flexible underwriting guidelines to facilitate . . . mortgages for very low-, low-, and moderate-income families."[4] The Federal agency supervising Fannie and Freddie was directed in this law to evaluate the extent to which Fannie and Freddie develop new loan products with "more flexible underwriting standards and other innovative approaches to providing financing" for these individuals.

Likewise, when the banking agencies began to impose restraints on bank lending for commercial real estate development in 2006, they were lambasted by Congress for choking off the flow of credit for commercial development, harming multifamily construction and housing projects, and potentially causing a recession.[5]

The essential problem is that it's difficult to detect a bubble when you are in the midst of one, and even more difficult to take actions to deflate a bubble in a democracy, where economic growth and development are supported by the public and Congress.

<u>Proposed Solution: Worse than the Problem?</u>

The current legislative proposals attempt to deal with the systemic risk problem by creating a financial oversight council, with the direction to prevent future problems by identifying bubbles and other risks, and then taking actions to avoid the damage that they may cause. Large bank holding companies and financial companies that are determined to be systemically significant will be subject to a host of new requirements, including significantly higher minimum capital levels, minimum liquidity requirements, a prohibition on investing in mortgage backed securities or corporate debt instruments, enhanced and more intensive examination and supervision, and

[4] Section 1129 of the Housing and Economic Recovery Act of 2008

[5] A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate Lending, Hearings Before the House Financial Services Committee (Sept. 14, 2006).

a host of other "prudential" regulations. Mortgage lending in particular will be subject to extensive new restrictions that will impose new costs on, and considerable legal risk for, mortgage lending.

As history demonstrates, these types of prescriptive regulations are not likely to be effective. Sooner or later another asset will be identified as worthy of investment, because it can "only go up" in value over time. Whether the asset is loans to developing countries, natural resources, batteries for electric cars, oil or gold, or something else, cannot be predicted. However, it can be predicted that there will be another bubble, and it can be predicted that the financial oversight council will not be able to deflate the bubble as long as the "conventional wisdom" believes that this is the new way to become wealthy, or that "this time it's different." The experience with the mortgage related securities indicates that it is just as likely that the oversight council will encourage investment in this asset (since it is so safe) rather than warn banks and financial companies away. The result will be another crisis and economic disruption, to be followed by another legislative bill promising "Never Again."

However, this is not to say that the legislation will not have significant impacts on financial companies. The oversight council's main responsibility is to prevent another systemic event in the financial services industry. In order to fulfill that mission it will likely impose new and more stringent prudential regulations. These regulations, as well as many other mandates in the bill, will reduce the ability of financial institutions to lend and fund economic growth, and financial institutions will be reluctant to make loans unless they have little risk. Credit to new ventures will be especially hard hit, as will mortgage lending. Compliance burdens and costs will increase, and these costs will reduce lending capacity further. The immediate effect will be to reduce capital available for economic growth. The costs will be high, and will be paid by all. The enhanced safety and soundness may be illusory, for the oversight council will not be able to actually prevent the next asset bubble, or to cut off funding for the next "sure thing" that can only go up in value. But attempts to do so will restrict the flow of capital necessary for our economic growth.

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