Regulatory Failures and Insufficiencies that Contributed to the Financial Crisis and Proposed Solutions

THE UNIVERSITY OF IOWA

University of Iowa Center for International Finance and Development

Erin Nothwehr & Tim Manning

Regulatory Failures Relating to Home Loan/Mortgage Origination and Associated Practices

•The issuance and subsequent mass-defaults of high-risk, subprime mortgages in the United States, as well as the predatory lending practices employed by many issuers of the subprime mortgages contributed to the exacerbation of the financial crisis.

•Regulatory failures or oversights in the area of mortgage origination affected both private sector lenders and government sponsored enterprises (GSEs). Specifically, the lax, or altogether non-existent regulation of the private-sector lending practices allowed these lenders to make loans to individuals who were either extremely high-risk or altogether unqualified for such loans.

- •Examples of largely unregulated, high-risk practices by these lenders include, but are not limited to: waiving or disregarding income, net worth, or employment requirements for loan recipients and, in extreme cases, falsifying qualifying documents.

•In addition to the above high-risk behaviors of private lenders, the policies governing the GSEs (i.e., Fannie Mae, Freddie Mac, the Federal Home Loan Banks) involved in the mortgage industry also contributed to the development of the credit crisis.

- •GSE policies aimed at increasing affordable housing actually resulted in a surge in the institutions' investment in high-risk subprime mortgages.

Possible Regulatory Solutions Relating to Home Loan/ Mortgage Origination and Associated Practices

•Economists, regulators, and legislators have offered a wide array of possible remedies for the inadequate regulation of the mortgage industry. These include:

- •Development—by the Federal Reserve, Federal Home Loan Bank, and/or HUD—of a comprehensive system of rules regulating mortgage lending.
- •Development of a uniform, national licensure scheme for mortgage lenders.
- •Implementation of a mortgage write-down system that would allow homeowners to avoid foreclosure by a modifying of the terms of their loans by the lending institution or (in certain versions of this proposal) by the courts or other government bodies.

•Also, here have been calls for a broad systemic overhaul of the foreclosure system, like that of the bankruptcy system in 2005.

Regulatory Failures Relating to the SEC Regulation of Investment Banks

•The crisis in the mortgage and housing market expanded to a systemic financial crisis due in large part to the activities of massive independent investment banks. These banks, largely through a number of complex means (including so-called "shadow banking"), invested heavily in high-risk mortgage backed securities (MBSs).

- •These risky investments, combined with the lack of regulation over investment banks, left the industry and the marketplace heavily exposed to the effects of the heavy downturn or collapse of the housing market.

•Prior to the development of the current financial crisis, legislation regulating securities, like the Graham-Leach-Bliley Act, failed to create any mechanism—within the Securities and Exchange Commission or any other agency—for the regulation of independent investment banks.

•In response to this major regulatory gap, the SEC established a voluntary system by which independent investment banks—such as Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns—could elect to submit to regulation over matters, such as minimum capital requirements and leverage limitations. This voluntary regulation program was called the Consolidated Supervised Entities (CSE) program.

•Largely due to EU requirements that they have a U.S. regulator, the investment banks voluntarily submitted to CSE supervision.

• However, the lack of any statutory authority, as well as the investment banks' ability to opt out of any CSE regulations, made the CSE essentially ineffective. Thus it failed to successfully regulate the activities of investment banks or to deter the advancement of the current financial crisis.

Possible Regulatory Solutions Relating to SEC Regulation of Investment Banks

•The independent investment banks that had submitted to voluntary CSE regulation have all collapsed, been acquired, or converted to bank-holding companies.

•As of September 2008, the SEC has disbanded the CSE program. The SEC continues to express its commitment to better regulate the entities and enterprises over which it has jurisdiction and to learn from the mistakes and missteps of the CSE program.

•While no comprehensive legislation or regulatory scheme has been proposed to specifically replace the CSE, some suggestions include: enacting legislation giving the SEC the statutory authority it lacked when creating the CSE, or relying on the Federal Reserve to police investment banking activities.

•Until responsibility for such regulation is definitively placed with either of these agencies, or perhaps with another agency altogether, the SEC and the Federal Reserve have executed a Memorandum of Understanding that commits them to work together to implement an effective scheme of regulation over the investment banking operations divisions of the bank-holding companies that have replaced the now nonexistent investment banks.

Regulatory Failures Relating to the "Shadow Banking" System

•Many attribute the expansion of the current crisis from the U.S. housing market to the global financial system to the actions, insufficient regulation, and eventual collapse of the "shadow banking" system.

•By using shadow banking mechanisms, such as structured investment vehicles (SIVs), collateralized debt obligations (CDOs), and credit default swaps (CDSs) to purchase, finance, and insure MBSs, many investment banks and other financial institutions were able to make these high-risk transactions off of their balance sheets and free from most regulations, which typically applied only to on-balance sheet transactions.

•By using special entities that made up the shadow banking system, financial institutions were able to make higher risk transactions and investments, not only because these high-risk transactions were hidden from normal accounting exposure and regulation, but also because these entities were not subject to the same risk-reducing minimum reserve requirements as were the commercial banks and other institutions, which in most cases were the parent institutions of the shadow banking entities in question.

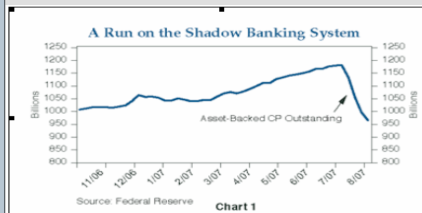

Chart 1

Possible Regulatory Solutions Relating to the "Shadow Banking" System

•Many in the financial community have called for the implementation, both at national and international levels, of minimum reserve requirements for all institutions and entities involved in the purchase of MBSs, the production of commercial paper, etc.

- •Such requirements would reduce the level of risk involved with purchase and trading of high-risk securities, like MBSs.

•Economists and regulators have also suggested the following changes to regulation of shadow banking activities:

- •More aggressive oversight and regulation of the risk management activities of all institutions and entities, both on- and off-balance sheet.
- •Elimination of over-the-counter trading of CDSs and development of a monitored international clearinghouse to facilitate such trades.
- •Heightened national and international disclosure requirements for financial institutions.

Regulatory Failures Relating to Accounting Practices

•Many within the financial and academic communities have blamed mark-to-market accounting, particularly its use in relation to inactive or illiquid markets (i.e., the current markets for housing or mortgage backed securities), for much of the damage caused by the current financial crisis.

•During the time leading to the current crisis (prior to the passage of the Emergency Economic Stabilization Act of 2008), FASB's Fair Accounting Statement 157 (FAS 157) principally regulated mark-to-market accounting.

- •FAS 157 "defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements." Furthermore, it defines fair value as "[t]he price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

•Mark-to-market rules, and problems and criticisms associated with them, are certainly not unique to the United States. Most major European countries govern the accounting practices of their companies with the International Financial Reporting Standards (IFRS), which are promulgated by the International Accounting Standards Board.

- •Rule 7, the IFRS' mark-to-market rule, is essentially identical to FAS 157.

•Specifically, critics allege that requiring banks and financial institutions to value assets at current market value, even if the market is temporarily depressed, causes these institutions to post massive, but ultimately artificial, losses. The aggregation of these "on-paper" losses, many argue, has served to greatly exacerbate the current financial crisis.

Possible Regulatory Solutions Relating to Accounting Practices

•There is great disagreement on how best to address the problems posed by the mark-to-market accounting rule.

•Many regulators, including those at the FASB and the SEC, have hesitated to make any changes to the rule, even though they have the authority to do so under the EESA.

•Members of the financial community, including the American Bankers' Association, have argued vehemently for a change, or possibly the suspension or elimination of the mark-to-market rule.

•While no final determination has been made by the SEC regarding mark-to-market accounting, the FASB has offered guidelines allowing for financial institutions to rely on estimates and certain financial modeling, as opposed to the depressed market prices, for determining the value of many financial assets. However, banks and other institutions insist that these guidelines are insufficient in addressing the problems caused by mark-to-market accounting.

•Some economists have suggested that the United States adopt the IFRS, thereby creating a uniform set of accounting standards across the globe. This would be a step toward alleviating or preventing the accounting-related problems in the current crisis. However, considering IFRS Rule 7 and the IASB's current adherence to mark-to-market accounting, this suggestion is met with considerable criticism from mark-to-market foes.

Regulatory Failures Relating to Credit Rating Agencies

•Credit rating agencies are blamed for mis-rating many complex financial products involving asset-backed securities, and for being too slow to downgrade these products in response to the deepening subprime crisis.

Possible Regulatory Solutions Relating to Credit Rating Agencies

•Critics of the credit rating agencies, especially with regards to the role they played in the development of the financial crisis, recommend the following courses of action and changes:

- •Avoidance of conflicts of interest, including avoidance of consulting on the structure of any product that will then be rated by the particular agency.
- •Greater degree of mandatory disclosure, both of information used to rate a product as well as information about the ratings-methodologies and "success" rates.
- •Differentiation by agencies of ratings for complex products so as to make clear to investors that the risks inherent in these products are different from those inherent to other debt securities.

Regulatory Failures Relating to the Basel Accords

•The Basel Committee on Banking Supervision was established by the Bank for International Settlements in 1976. It issued a consultative paper on the capital adequacy requirements of international banks in 1988, which is commonly referred to as the Basel I Accord (Basel I). The primary motivation for Basel I was to reduce risk posed to the global financial system by banks not holding enough capital to offset their risky investments.

•Under Basel I, banks must hold an 8% minimum of risk-weighted assets to be considered adequately capitalized. Basel I separates the assets held by banks into four different risk buckets, each requiring a different percentage of capital to be held against the possibility of loss.

•Banking supervisors soon started to complain about the flaws in the Basel I framework. Although implementing Basel I appeared to increase the capital held by banks, two of its shortcomings came under attack.

- •First, the risk buckets did not accurately reflect the real world risk associated with the assets.
- •Second, banks took advantage of the fact that Basel I allowed for lower charges against capital for off-balance sheet activities. Specifically, banks could lower their capital charges by securitizing their loans.

•The Basel Committee responded to the criticisms by issuing Basel II in 2004.

- •Basel II was issued with the same underlying motivation as Basel I: To reduce the risk posed to the global financial system by undercapitalized banks.
- •Basel II was supposed to be an improvement on Basel I. It was designed to better assess the risk of the assets held by the banks than did Basel I. To achieve this goal, Basel II relies on the risk ratings made by the credit rating agencies (CRAs) or internal risk assessments performed by the banks themselves.
- •Unlike Basel I, Basel II also recognizes short-term off-balance sheet activities, such as credit enhancements, when assessing the risk of assets held by banks.

•The financial crisis has highlighted some of the shortcomings of Basel II. These include the framework's dependence on CRAs or internal risk assessment models to determine the risk of assets held by banks; lower capital requirements for residential mortgages; and no capital requirements for off-balance sheet activities that are not contractually tied to the banks. Additionally, Basel II did not address Basel I's low capital requirements for off-balance sheet activities, and did not provide for adequate disclosures related to complex structured finance products.

Possible Regulatory Solutions Relating to the Basel Accords

•In light of the global financial crisis, the Financial Stability Forum (FSF) released a report in April 2008, proposing recommendations on strengthening Basel II. The report suggested that Basel II require higher capital ratios and greater disclosures for complex financial products. The FSF also concluded that Basel II should provide better guidance on risk management practices, which include off-balance sheet exposures and the associated reputational risks for banks. The Basel Committee responded to the FSF's proposed recommendations in consultative papers issued in January 2009. The papers propose, inter alia, to increase capital charges for assets held in banks' trading books, to improve risk management in supervising banks, and to increase disclosure of banks' exposure to securitized instruments to better reflect real risk.

•Many commentators blame liquidity problems within the banks, not their capital adequacy, for the current crisis. The Basel Committee addressed concerns about liquidity in a paper released in September 2008. This paper listed 17 principles a bank should follow when managing its liquidity risk but did not contain any formulas. Some academics believe that the Basel Committee should create an international benchmark for liquidity standards such as a minimum leverage ratio.

www.PosterPresentations.com