



## Lots of Regulatory Expansion but Little Reform

By Alex J. Pollock

*In the wake of every financial crisis, politicians face the demand that they Do Something. They feel they have to enact something to “make sure this never happens again”—although historically it has always happened again anyway. Moving the boxes on the regulatory organization chart and expanding regulatory powers are always available options, and the financial regulatory bills currently under consideration in the House and Senate display the typical process of doing both. Missing from the bills, however, are strategies to create countercyclical elements to moderate swings, as well as reforms for Fannie Mae and Freddie Mac, the government-sponsored enterprises at the center of the housing bubble. Absent those reforms, the proposed regulations will do little to address the flaws that caused the crisis in the first place.*

The U.S. Senate’s financial “reform” bill, consisting of over 1,500 pages of regulatory expansion, is in conference along with a similar 1,300-page bill from the House of Representatives. “There is little in [this] bill that would have prevented the financial crisis of 2007–2009, or the next crisis,” concludes William Isaac, who headed the Federal Deposit Insurance Corporation (FDIC) during the financial crisis of the 1980s, which included the failure of 2,400 banks and thrifts.<sup>1</sup> The bill is unlikely to achieve its own goal of preventing another crisis, but it is certain to produce an efflorescence of bureaucratic interventions, red tape, and costs.

### Moving the Regulatory Boxes: A Committee, That’s What We Need!

Among the Senate bill’s regulatory reorganization ideas is forming a Financial Stability Oversight Council—a cumbersome committee made up of the Treasury Department, Federal Reserve Board, Securities and Exchange Commission, Commodity

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Futures Trading Commission, Office of the Comptroller of the Currency, FDIC, Federal Housing Finance Agency, Consumer Financial Protection Bureau (CFPB), and one “independent member.” According to the Senate Banking Committee’s

#### Key points in this Outlook:

- Under political pressure to “do something” in the wake of a financial crisis, Congress can always move the regulatory organizational boxes.
- Since the government is itself one of the key causes of financial bubbles, moving the boxes is unlikely to prevent future crises.
- The strategy of expanding regulation assumes that regulators have superior knowledge of the future. There is no evidence that they do. Regulators are as likely to make the same intellectual mistakes as anybody else.
- In spite of a 1,500-page bill, Congress has made no move toward fixing the government’s massive blunder at the center of the housing bubble and crisis, namely Fannie Mae and Freddie Mac.

description of the bill, this committee “will have the sole job to identify and respond to emerging risks throughout the financial system.”<sup>2</sup>

But committees are political bodies. Faced with this assignment—which is an intellectual, not a political, challenge—will such a committee succeed? It is hardly likely. In spite of other reorganizational regulatory labors over the years, financial crises continue to happen again anyway. Why? One reason is that the government itself is a key cause of the crises: in the twenty-first-century bubble and bust, see the combined effects of the Federal Reserve, Fannie Mae, Freddie Mac, and the “national home ownership strategy.” A second reason is that reorganizing regulatory bureaucracies, or forming them into committees, does not address their fundamental problem: the inability to know the future.

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Donald L. Kohn, vice chairman of the Federal Reserve Board, pointedly observed: “Many central bankers and economists, myself included, were a little complacent coming into the crisis. We thought we knew enough about the basic structure of markets and the economy. . . . The reality is that we didn’t understand the economy as well as we thought we did. Central bankers, along with other policymakers, . . . failed to foresee or prevent a financial crisis.”<sup>3</sup> Unsurprisingly, “the regulators made the same cognitive errors as the regulated,” as insightful analyst Arnold Kling recently said.<sup>4</sup> As the bubble was inflating, for example, the FDIC opined that “it is highly unlikely that home prices will fall precipitously across the entire country.”<sup>5</sup> This was the common view at the time, and it was quite reasonable—but wrong.

So what is the real role of the Financial Stability Oversight Council? One government insider suggested to me that it was just for show and not really expected to do anything. A realistic but less cynical view suggests that it represents exactly the kind of political compromise you would expect from a committee—the Senate Banking Committee, in this case. Either interpretation is plausible.

## **Intrusion without Limits: The Consumer Financial Protection Bureau**

Another proposed move of the boxes on the regulatory organization chart is the CFPB, an agency thinly disguised as part of the Federal Reserve Board but obviously designed to be an aggressively independent operation. Any objective observer of government-agency behavior would predict that this will become a large, expensive, highly intrusive additional financial bureaucracy. With arbitrarily expanding demands, it will impose heavy costs on consumer financial services and requirements that likely conflict with those of other financial regulators.

Treasury Secretary Timothy F. Geithner, in remarks at AEI in March 2010, said the CFPB would be “overwhelmingly focused on improving disclosures, so consumers can have better ways of making informed choices.”<sup>6</sup> Indeed, providing clear, straightforward key information so borrowers can exercise greater personal responsibility in making decisions to undertake debt commitments is an excellent goal. But it does not require a new agency. Moreover, it is highly unlikely that this would be the “overwhelming focus” of such an organization as it would inevitably evolve.

Consider a new, independent regulatory bureaucracy filled with ambitious officers and staffers who are interventionist by ideology, believers that people need to be guided for their own good according to the tenets of “behavioral economics,” social democratic by faith, and closely aligned to numerous “consumer advocates.” Public choice theory suggests that they will hardly be content with the project of “improving disclosure,” important as that is. Their ambitions will be further fired by the provision that the CFPB’s director would become a member of the FDIC board—a provision that gets the correct relationship exactly upside down. They will ineluctably embark on allocating credit in terms of “improved access” and “fairness,” probably trying to use the FDIC for that purpose. In other words, they will promote expanding riskier loans, in spite of the fact that making people loans they cannot afford is the opposite of protecting them.

This is why, if such an organization is to be created, it would be much better to make it part of, and subordinate to, a regulatory body also charged with financial prudence, safety and soundness, and balancing risks. Even better would be not to create a new bureaucratic agency at all, but rather to centralize the responsibility for clear, straightforward key information in a relevant existing

regulator such as the Federal Trade Commission. But the congressional majority looks dead set on bringing forth a new bureaucracy.

## The Key Missing Idea: Countercyclical Strategies

The 1,500-page regulatory-expansion bill is missing the single most fundamental idea for addressing bubbles and financial crises: strategies to create countercyclical elements to moderate the swings. Cycles in economics and finance are inevitable. The dream of preventing them with macroeconomic fine-tuning was given up long ago. Many factors, such as the mass psychology of confidence versus fear, are procyclical, exaggerating both the ups and downs. Great numbers of people making a lot of money from bubbles while they last, which may be for many years, and then losing a lot of money with great rapidity is procyclical. Fair value accounting is also procyclical.

Regulation itself is one of the important procyclical factors—a problem well known to theoreticians of financial regulation. This is especially true in the down cycle. Reflecting the bust, regulators, afraid of being criticized, seeing that their deposit insurance fund is out of capital, and reacting to the mistakes already made, clamp down forcefully on banks. This contracts credit further than the crisis already has.

One prominent banking lawyer put it this way: “Regulators are now, as usual, tightening the noose.”<sup>7</sup> Geithner told Congress recently that too-strict regulatory actions could block small-business credit. “Frankly, they could do more to make sure that examiners are not overdoing it,” he testified.<sup>8</sup> But overdoing it is natural when the losses and risk of further loss are so obvious.

Hence there is an international discussion of how one might introduce countercyclical factors. There are at least three promising ideas, none of which, unfortunately, appear in the regulatory-expansion bill:

**Develop Countercyclical Loan-to-Value Ratios.** The most important idea is to develop countercyclical loan-to-value ratio (LTV) behavior, particularly for housing finance. Typically in a housing-price boom, as both lenders and borrowers grow more optimistic, the LTV—the amount the lender is willing to risk against the current market price of the property—tends to go up. LTVs of 95 percent, 100 percent, or even more begin to seem acceptable. Down payments then get smaller or nonexistent. This typical LTV behavior is exactly the

opposite of what should happen. As any asset price goes up in exaggerated fashion, the risk of its subsequent fall grows geometrically. Thus, the LTVs should not even be steady—they should be reduced as housing prices inflate above their trend.

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Representative Bill Foster (D-Ill.), a member of the House Financial Services Committee and a Harvard Ph.D. physicist, observes that we need something like a feedback controller, well known to engineering theory. He proposes a simple method: determine the maximum LTV (and thus the minimum down payment) using the regional increase in housing prices over the last three years, not just the current price. Rapid housing-price inflation would automatically reduce LTVs and increase down payments. His proposed rule thus “treats skeptically the value of [rapidly] appreciated assets.”<sup>9</sup> Such ideas need to be energetically pursued.

**Provide Bigger Reserves in Good Times.** Similarly, lending institutions need to provide much bigger, old-fashioned reserves for loan losses while the good times last. A true banking dictum is that bad loans are made in good times. Spain is the one country that has notably required such countercyclical reserves; its banks still made a lot of bad real estate loans, but the bigger reserves have cushioned the blow. The principal obstacles to implementing this obviously good idea are the Securities and Exchange Commission and the Financial Accounting Standards Board. Both have worked hard to reduce loss reserves for fear that profits would be understated, which caused profits to be wildly overstated. These agencies need to be moved out of the way.

**Encourage New Banks in Bad Times.** A good countercyclical strategy is to encourage new banks in bad times, when credit standards are high and the economy needs new credit from lenders that are not stuck in the tar pits of past losses. The current regulatory practice is the opposite of this. It needs to be reversed.

Countercyclical strategies would represent true reform and fundamental improvement. Merely multiplying regulatory powers does not.

## A Flawed Model: The FDIC

The regulatory-expansion bill contains a particularly great expansion of regulatory power over large financial companies that are not banks. It gives the Federal Reserve wider jurisdiction and regulators joint power to order a liquidation of such companies. The FDIC would administer the liquidation as it now does with failed banks; thus the bill would greatly expand the agency's power. The House bill would also create a "systematic resolution fund" on the model of the FDIC's deposit insurance fund.

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But is the FDIC an attractive model to expand upon? Consider this Bloomberg headline: "FDIC Is Broke."<sup>10</sup> Indeed, the FDIC fund is insolvent, with a net worth of negative \$21 billion as of the end of 2009. When the fund had about \$50 billion, it was judged more than adequate.

As the FDIC's deficit net worth continues, numerous banks continue to fail. By some estimates, there are several hundred bank failures yet to go in this cycle. The losses to the FDIC as a proportion of failed bank assets in this cycle are running much higher than the historical average, notwithstanding the FDIC Improvement Act of 1991 and constant heavy regulation of banks in the meantime. The result is that the FDIC is completely dependent on its guaranty from the U.S. Treasury.

Another experiment with deposit insurance, the Federal Savings and Loan Insurance Corporation (FSLIC), ended in deep insolvency and was abolished in 1989, passing about \$150 billion in losses to taxpayers. Taxpayers are still paying on the bonds issued to finance that bailout of twenty years ago.

Regarding its proposal, the Senate Banking Committee says, "Industry, not the taxpayers, will take a hit for liquidating large, interconnected financial companies."<sup>11</sup> Have we ever heard that before? Well, here is what Henry Steagall, the sponsor of the original deposit insurance act,

declared in 1933: "I do not mean to be understood as favoring the government guaranty of bank deposits. I do not. I have never favored such a plan. Bankers should insure their own deposits."<sup>12</sup> The government has had to guarantee both the FSLIC and the FDIC anyway.

Some may think that the FSLIC and savings and loan experience is not relevant to current problems because the savings and loans were so concentrated in real estate. This thought is wrong. The entire banking system today has an extreme concentration in real estate risk, which has been building up consistently since the mid-1970s, although the FDIC and the Fed have been regulating away all the while.<sup>13</sup>

How did the banks get their hands on so much money to bet on real estate? Through deposit insurance and the FDIC, of course, making the providers of deposits to banks completely indifferent about what the banks are doing with their money. This is the notorious moral-hazard problem, which neither the FDIC model nor any other system of government-supported risk taking can escape. The role of the FDIC is essential to understanding the bubble, but it is the forgotten moral hazard of this cycle.<sup>14</sup>

## Meddling in Corporate Governance

With very little focus or discussion, the Senate bill has slipped in a series of intrusive provisions meddling in the internal governance of corporations. These are controversial and deserve separate and serious legislative examination. They include provisions on the election of corporate directors, shareholder votes, corporate leadership roles, compensation, the composition and functioning of board-compensation committees, and the voting of shares in customer accounts by brokerage firms. One commentator has called this bill "the biggest corporate governance power shift in the history of the modern American company."<sup>15</sup>

None of these provisions appears to have considered the reality of today's capital markets: the majority of people claiming to be "shareholders" are not themselves the owners of the stock. Instead, they are merely agents—typically the hired management of institutional funds—with their own serious incentive or principal-agent conflicts. These may include promoting political agendas under the guise of being investors, such as the agendas of labor unions through their pension funds. Such agents are no more the real corporate owners than are the brokerage firms whose votes are being restricted. These issues are

discussed in detail in my AEI *Financial Services Outlook* “Will the Real Shareholders Please Stand Up? Principals and Agents in the Sarbanes-Oxley Era.”<sup>16</sup> No legislation that does not begin by appreciating the true nature of this “agency capitalism”—and the current regulatory-expansion bill clearly does not—can be adequate.

## Fixing the Government Blunder at the Center of the Crisis: Maybe Next Year

At the center of the financial crisis was the housing-finance bubble. At the center of the bubble were Fannie Mae and Freddie Mac, using the guaranty of the government to inflate housing credit and thereby to inflate house prices. Fannie and Freddie were and are government projects, operating under a U.S. Treasury guaranty previously said to be “implicit,” but real nonetheless, as events have demonstrated.

Fannie and Freddie’s political supporters maintained the faith until very late in the game: “What’s important are facts—and the facts are that Fannie and Freddie are in sound situation. . . . They’re in good shape.”<sup>17</sup> Thus said Senate Banking Committee chairman Christopher Dodd (D-Conn.) in July 2008—just as Fannie and Freddie were about to go down for the count.

Under pressure from the government’s “affordable housing goals,” Fannie and Freddie accumulated \$700 billion of higher-risk loans and investments—nearly \$200 billion of nonprime mortgage-backed securities and \$500 billion of nonprime mortgage loans, according to the Congressional Budget Office’s count.<sup>18</sup> Peter J. Wallison and Edward Pinto calculate that the risky loans and investments were much more than that, about \$1.6 trillion.<sup>19</sup> In addition, Fannie and Freddie ran at very high and risky leverage, a perfect case of James Grant’s dictum: “Let profit-maximizing people come to believe that the [government] will bail them out, and they will assume the leverage that requires them to be bailed out.”<sup>20</sup> And so they did, and so they were.

The Congressional Budget Office calculates that the activities of Fannie and Freddie, if properly accounted for, added \$291 billion to the federal deficit, with more to come. They opine, correctly, that realism dictates that Fannie and Freddie be accounted for on the federal budget. Congress cannot bring itself to adopt honest accounting, however. The Democratic majority voted down an amendment proposing it—heavily ironic considering the many speeches given in other contexts about

the need for “transparency” in financial reporting (reporting by other people, of course) and the problems of off-balance-sheet financing. The administration argues for smaller numbers and continuing off-balance-sheet treatment, estimating the cash cost of Fannie and Freddie’s failure will be only \$177 billion.<sup>21</sup> Either way, that is more than the \$150 billion cost of the infamous savings and loan collapse.

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Any way you look at it, Fannie and Freddie count as an enormous government blunder. Reforming the bubble-inflating housing-finance system without reforming Fannie and Freddie is impossible.

As objective observers cannot help noticing, however, the 1,500-page regulatory-expansion bill somehow cannot find room to address Fannie and Freddie. Meanwhile, the administration has said it wants to start reform of Fannie and Freddie in 2011. In 2009, they said they would make reform proposals in 2010. So, for reform properly so called, as Chicago Cubs fans have been saying for more than a century, “Maybe next year!”

## Expanded Regulation versus Knowledge

Overall, as financial strategist Leo M. Tilman has observed, “the financial reform currently in the works myopically focuses on the regulatory dimension.”<sup>22</sup> To try to address financial crises by a strategy of regulatory expansion relies on the assumption that regulatory bureaucracies have superior knowledge of what causes the financial future. There is no evidence that they have such superior knowledge.

How about superior wisdom? “All of this new regulation depends on the wisdom of regulators,” David Leonhardt reflected in the *New York Times*.<sup>23</sup> Does this dependence make you more hopeful? Apparently it has not had this effect on Secretary Geithner, who has written, “We cannot build a system that depends on the wisdom and judgment of future regulators.”<sup>24</sup> But Congress is trying to build one anyway.

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