Matt Yglesias

Today at 9:14 am

Financial Regulation Flashback

Mike Konczal takes a look at the trajectory of the Cato Handbook for Policymakers over the past 15 years and finds that basically nothing has changed. The exception is that the 2009 edition doesn't mention Cato's longstanding desire to abolish the FDIC but doesn't repudiate that position either. Something that I thought was interesting here, however, is that you get to look at what pre-crisis versions of post-crisis hobbyhorse complaints looked like. For example, we've heard a lot from the right about the idea that the Community Reinvestment Act somehow caused the financial crisis by pressuring banks into extending bum loans to low-income borrowers.

But if we look back at the 2003 edition of the Handbook (PDF) we can see that the pre-crisis critique of the CRA was totally different:

> There is evidence, however, that the **CRA has had at least four negative effects on the communities that it seeks to**

> **help**. First, outside banks seeking mergers or an expansion of their activities will provide subsidized loans in low-income neighborhoods to avoid CRA-related problems, thus misallocating capital and driving customers away from local institutions that would have otherwise provided credit to local borrowers. Second, the CRA makes it difficult for banks to close branches in distressed areas. The unintended consequence is that other banks that might consider opening new branches in low-income neighborhoods may choose not to do so lest they be unable to close them at a future date. In the end, there is less competition in those areas and consumers suffer. Third, the CRA prevents banks from specializing in servicing specific groups because the banks do not want to be accused of discriminating against other groups. **Finally, by increasing the costs to banks of doing business in distressed communities, the CRA makes banks likely to deny credit to marginal borrowers that would qualify for credit if costs were not so high**. Chief among those costs is the hundreds of millions of dollars in CRA loans that community activists obtain from banks to give their approval of bank mergers and other bank expansions of activities, in an exercise that can be characterized as legalized extortion.

By this logic, whatever problems there may be with the CRA it should actually have made the current crisis *less* severe than it otherwise would have been by constraining the ability of lenders to offer loans to even-less-creditworthy borrowers than the ones who actually got subprime loans. By contrast, the 2003-vintage criticism of Fannie & Freddie holds up quite well noting that "they have in recent years begin . . . to enter the subprime mortgage markets, where the credit risk is much higher."

The larger issue is the general attitude toward financial regulation. By

the 2000s, financial services in the United States were much less regulated than they'd been several decades earlier. At the same time, they were hardly un-regulated. Consequently, since the crisis there's been a debate between those who blame the meltdown on the process of deregulation and those who contend that it was the failure to fully de-regulate that was to blame. But what were people saying in 2003? This was Cato's take:

> **Technological change and financial innovation have radically transformed the financial services marketplace in the last few years to the benefit of financial services firms and consumers alike**. More important, the transformation will likely continue in the coming years and financial regulations are unlikely to be able to keep up with market developments, which could prevent an efficient and sound modernization of the U.S. financial system. **Although the process of modernization will not necessarily be smooth, regulators and Congress must resist temptations to go back to the old, rigid structure that came undone with the Gramm-Leach-Bliley Act. Market forces, if allowed to do so, can be very effective in exerting the discipline necessary to minimize conflicts of interest and in correcting any shortcomings that may come along the way**. Congress should continue with the elimination of the regulatory burden to which financial services firms are subject and let the shape of the financial marketplace be determined by buyers and sellers of financial services.

My read is that though Cato was by no means calling the pre-crisis status quo *ideal*, they were reasonably satisfied with it. They were alarmed by the prospect of re-regulation, and eager to see some further de-regulation, but far from panicked about the status quo and certainly not raising alarm bells *at the time* about the idea that the

existence of some continued government involvement in housing finance was likely to produce any kind of systemic economic crisis.

- Comments
- 3

3 Responses to “Financial Regulation Flashback”

1. *Eli* says:
   August 31st, 2010 at 9:36 am

   Well, private markets will self-regulate because private markets will self-regulate. Duh!

   Thinking is so easy…

2. *LaFollette Progressive* says:
   August 31st, 2010 at 10:01 am

   Market forces, if allowed to do so, can be very effective in exerting the discipline necessary to minimize conflicts of interest and in correcting any shortcomings that may come along the way.

   Once more, with feeling!

3. *Roader* says:
   August 31st, 2010 at 10:31 am

The Mounting Case For Privatizing Fannie Mae And Freddie Mac, Vern McKinley, *Cato Policy Analysis*, **December 29, *1997***:

> **The GSEs Help the Relatively Affluent, Not the Poor**
> **The GSEs as Corporate Welfare**
> **The GSEs as Financial Time Bombs**

Fannie Mae, Freddie Mac, and Housing Finance
Why True Privatization Is Good Public Policy, Lawrence J. White, *Cato Foundation*, **August 11, *2004***:

> Congressional hearings that consider the legislation that the Treasury (after the passage of the privatization legislation) would treat the two companies just like other corporations in the U.S. economy, would not consider the two companies to be "too big to fail," and would have no intention of "bailing them out" in the event of subsequent financial difficulties. The President should reiterate this message at the official signing of the legislation. Also, bank and S&L regulators should revise their "loans-to-one-borrower" regulations so that depositories' holdings of Fannie Mae and Freddie Mac debt would be treated similarly to their holdings of other companies' debt (i.e., loans to any single borrower normally cannot exceed 10% of the depository's capital), rather than the unlimited holdings that are currently permitted.

(2)