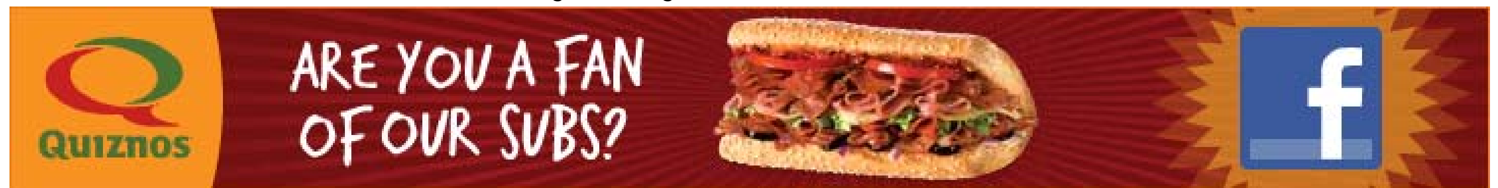

The Christian Science Monitor

The Daily Reckoning

Misguided regulations caused the financial mess

Did regulations intended to improve the operations of banks unintentionally cause the financial crisis?

By Rocky Vega

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02/20/10 Stockholm, Sweden –

So many explanations have been offered for the financial crisis, then reheated and reexamined, that it's nearly impossible to imagine a new theory worth considering. However, Jeffrey Friedman of the Cato Institute has found one. He looks at a little-discussed regulatory mechanism that incentivized banks to put a disproportionate share of capital into what turned out to be some very toxic assets.

Friedman explains in the Cato Policy Report:

> "In 1988, financial regulators from the G-10 agreed on the Basel (I) Accords. Basel I was an attempt to standardize the world's bank-capital regulations…
>
> "It differentiated among the risks presented by different types of assets. For instance, a commercial bank did not have to devote any capital to its holdings of government bonds, cash, or gold — the safest assets, in the regulators' judgment. But it had to allot 4 percent capital to each mortgage that it issued, and 8 percent to commercial loans and corporate bonds…
>
> "The United States implemented it in 1991 [...] Ten years later, however, came what proved in retrospect to be the pivotal event. The FDIC, the Fed, the Comptroller of the Currency, and the Office of Thrift Supervision issued an

> amendment to Basel I, the Recourse Rule, that extended the accord's risk differentiations to asset-backed securities (ABS): bonds backed by credit card debt, or car loans — or mortgages — required a mere 2 percent capital cushion, as long as these bonds were rated AA or AAA or were issued by a government-sponsored enterprise (GSE), such as Fannie or Freddie.
>
> "Thus, where a well-capitalized commercial bank needed to devote $10 of capital to $100 worth of commercial loans or corporate bonds, or $5 to $100 worth of mortgages, it needed to spend only $2 of capital on a mortgage-backed security (MBS) worth $100.
>
> "A bank interested in reducing its capital cushion — also known as 'leveraging up' — would gain a 60 percent benefit from trading its mortgages for MBSs and an 80 percent benefit for trading its commercial loans and corporate securities for MBSs."

As Friedman describes above, the regulations intended to improve the operations of the banks instead put the wheels in motion for a financial mess. It shows how oftentimes meddling in a system is worse than leaving it alone.

For more details and insight into the causes and consequences of the financial crisis visit the Cato Policy Report's coverage of a perfect storm of ignorance.

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