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Financial Market Reform

Why new regulations must avoid moral hazards

Jeffrey A. Miron | October 27, 2009

In the coming weeks and months, Congress will be turning its attention to financial market reform, in hopes of avoiding future financial crises. According to perceived wisdom, the root cause of the 2008 financial crisis was excessive risk-taking, and proper regulation can detect and prevent such excess in the future.

This view is a pipe dream. Most new regulation will do nothing to limit crises because markets will innovate around it. Worse, some regulation being considered by Congress will guarantee bigger and more frequent crises.

Government-Induced Moral Hazard Caused the Crisis

The Financial Crisis of 2008 did not occur because of insufficient or ill-designed regulation. Rather, it resulted from two misguided government policies.

The first was the attempt to promote homeownership. Numerous policies have pursued this goal for decades, and over time they have focused mainly on homeownership for low-income households. These policies encouraged mortgage lending to borrowers with shaky credit characteristics, such as limited income or assets, and on terms that defied common sense, such as zero down payment.

The pressure to expand risky credit was especially problematic because of the second misguided policy, the long-standing practice of bailing out failures from private risk-taking. This practice meant that financial markets expected the government to cushion any losses from a crash in mortgage debt. Thus, the historical tendency to bail out creditors created an enormous moral hazard.

One crucial component of this moral hazard was the now infamous "Greenspan put," the Fed's practice under Chairman Alan Greenspan of lowering interest rates in response to financial disruptions that might otherwise cause a crash in asset prices. In the early to mid-2000s, in particular, the Fed made a conscious decision not to burst the housing bubble and instead to "fix things" if a crash occurred.

It was inevitable, however, that a crash would ensue; the expansion of mortgage credit made sense only so long as housing prices kept increasing, and at some point this had to stop. Once it did, the market had no option but to unwind the positions built on untenable assumptions about housing prices. Thus government pressure to take risk, combined with implicit insurance for this risk, were the crucial causes of the bubble and the crash. Inadequate financial regulation played no significant role.

New Regulation Must Avoid Moral Hazard

If government-induced moral hazard caused the crisis, then new regulation should avoid creating or exacerbating this perverse incentive. Yet two components of proposed regulation will increase, rather than decrease, the chances for moral hazard.

One proposed change in regulation would give the Federal Reserve increased power to supervise financial institutions, especially bank holding companies such as Citigroup or Bank of America. This approach is a triumph of hope over experience. Why should an expanded Fed role be beneficial when the Fed erred so badly in the previous instance?

Defenders of an expanded Fed role will claim that, in the lead up to the crisis, the Fed did not have explicit powers to supervise and monitor non-bank financial institutions, and that such powers could have avoided the crisis.

Yet during the years before the crisis, the Fed had more than ample power to recognize the unprecedented level of risk that was building in the economy and to issue stern warnings, whether or not it had explicit regulatory authority. In fact, far from cautioning the market to behave, the Fed promoted the notion that it could solve any problems that might result from a bursting of the housing bubble.

Regulators are fallible. Alan Greenspan, once thought to be the Maestro, got it fabulously wrong. Ben Bernanke, regardless of the merit's of his stewardship, will not be Fed chairman forever. Centralized and expanded power to make things better is also centralized and expanded power to make things worse. In particular, any mistakes made by a powerful, centralized authority have a magnified impact because they distort the behavior of the entire market.

Just as problematic as granting the Fed additional powers is the proposal to allow the FDIC to resolve bank holding companies using taxpayer funds. Under the proposed arrangement, the FDIC rather than bankruptcy courts would be responsible for bank holding companies, and the FDIC would be authorized to make loans to failed institutions, to purchase their debts and other assets, to assume or guarantee their obligations, and to acquire equity interests. The funds would be borrowed from Treasury.

This means that FDIC resolution of bank holding companies would put taxpayer skin in the game, a radical departure from standard bankruptcy and an approach that mimics the actions of the U.S. Treasury under TARP. Thus, the new approach would institutionalize TARP.

The result will be that under the proposed system, bank holding companies would forever more regard themselves as explicitly, not just implicitly, backstopped by the full faith and credit of the U.S. Treasury. That is moral hazard in the extreme, and it will create an unprecedented incentive for excessive risk-taking by these institutions.

The Bankruptcy Approach

The only way to limit financial panics is to eliminate government-induced moral hazard, and that means letting failed institutions fail. Whether resolution is carried out by the FDIC or a bankruptcy court is not the crucial question; rather, it is whether that resolution process forces all the losses on the institution's stakeholders rather than bailing them out with taxpayer funds.

The standard objection to allowing failures is that some financial institutions are allegedly so large or interconnected that their failure causes a breakdown of the credit mechanism, thereby harming the whole economy rather than just transmitting losses that have already occurred. According to this view, letting Lehman Brothers fail was a crucial mistake that initiated the meltdown, and bailing out other financial institutions was a necessary evil to prevent even further chaos. Nothing could be further from the truth.

Rather than being a cause, Lehman's failure was merely the signal that time had come for the U.S. economy to pay the price for all the distortions caused by the misguided policies toward housing and risk. Given those distortions, a massive unwinding and restructuring was necessary to make the economy healthy again.

This restructuring required lower residential investment, declines in stock and housing prices, and shrinkage of the financial sector. All of this implied a recession, even without any impact of financial institution failures on the credit mechanism, and the recession meant that lending would contract, even without a credit crunch.

The bailout itself, moreover, caused much of the financial market turmoil. The announcement that the Treasury was considering a bailout scared markets and froze credit because bankers did not want to realize their losses if government was going to bail them out. The bailout introduced uncertainty because no one knew what the bailout meant. The bailout did little to make balance sheets transparent, yet the market's inability to determine who was solvent was a key reason for the credit freeze.

Thus letting Lehman fail was the right decision; bailing out Bear Stearns, Fannie, and Freddie in advance of Lehman, and the rest of Wall Street afterwards, were the mistakes. For all its warts, bankruptcy rather than bailout is the right way to resolve non-bank financial institutions. Any regulation that formalizes bailouts creates an enormous moral hazard and a black hole for taxpayer funds.

The Future

To limit future financial crises, policy must first avoid the distortions inherent in the attempt to expand homeownership. This means eliminating the Federal Housing Administration, the Federal Home Loan Banks, Fannie Mae, Freddie Mac, the Community Reinvestment Act, the deductibility of mortgage interest, the homestead exclusion in the personal bankruptcy code, the tax-favored treatment of capital gains on housing, the HOPE for Homeowners Act, the Emergency Economic Stabilization Act (the bailout bill), and the Homeowners Affordability and Stability Plan. None of this is sensible policy.

In addition, policy must end its proclivity to bail out private risk-taking. This second task is difficult, since it requires policymakers to "tie their own hands." Specific changes in policies and institutions can nevertheless support this goal. The first is avoiding new regulation that makes bailouts more likely. A second is repealing all existing financial regulation, since this would signal markets that they, and only they, can truly protect themselves from risk.

The third and perhaps most important way to reduce moral hazard is to eliminate the Federal Reserve. As long as the Fed exists, it will regard itself as, and be regarded as, the economic insurer of last resort. In a world with perfect information, appropriately humble central bankers, and an absence of political influence on monetary policy, such a protector might enhance the economy's performance on average.

In the world we live in, none of these conditions will hold consistently, so the potential for policy-induced disasters is large. The U.S. economy prospered for its first 125 years without a central bank. It's time to try that approach again.

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