



Another “Deregulation” Myth

By Charles W. Calomiris

Media reports and the Barack Obama campaign continue to propagate the fiction that the current financial crisis was caused, in large part, by Republican deregulation. The commonly used example is the 2004 change in the Securities and Exchange Commission’s (SEC) rule on net capital. The rule change, which proved unsuccessful in avoiding the problems at Lehman Brothers and Bear Stearns, was not an example of deregulation but of failed regulation.

Even after documenting the many ways that Washington encouraged the housing bubble, the media and Democrats continue to search for evidence to blame it all on “deregulation.” One alleged perpetrator, the Gramm-Leach-Bliley Act, was released without charges after the record revealed that Senator Joe Biden voted for it and Bill Clinton signed it into law. More to the point, investment banks were already free—prior to the 1999 law—to invest in the same assets that have wreaked such havoc today.

Obama nonetheless attacks President Bush’s policies to “strip away regulation,” without mentioning a single example. In an attempt to fill out Obama’s talking points, the press have now fingered a 2004 change in SEC net capital rules. In fact, then-SEC chairman William Donaldson’s reform was anything but deregulation. A regulatory failure, yes, and a cautionary tale for those who think new regulation will solve everything.

The 2004 change won unanimous approval from SEC commissioners and Democrat Annette Nazareth, who ran the market regulation division at the time. Rather than deregulation, it was a breathtaking regulatory leap for an agency that had traditionally focused on protecting individual investors. Under the new program, the SEC

would not simply monitor broker-dealers to ensure that client accounts were safe, but the commission staff would collect new data from the parent companies of brokerages and require new monthly and quarterly reports. Firms were supposed to provide detailed explanations of internal risk models.

Before approving the rule at an April 2004 meeting, several commissioners wondered if the SEC staff was up to the task. Apparently it was not. It is clear from a recording of that meeting that the commission expected investment banks to employ more debt. This was no unintended consequence but the inevitable result of adopting the so-called Basel II banking standards. The SEC was supposed to apply these standards created for commercial banks to investment banks, but with additional measures to ensure liquidity.

Was Basel II a libertarian plot cooked up at the Cato Institute? Not quite. It was the product of many years of effort by the world’s major central banks, intended to avoid crises such as the savings and loan disaster of the 1980s. Basel embraced the theory that a common set of global banking standards and more intensive study of the risks of particular assets would yield a more efficient use of capital and a more stable financial system.

We now know it did not create stable investment banks, but the SEC could be forgiven for

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thinking that if it was good enough for the world's central bankers, it was good enough for the commission. As Nazareth said of the SEC's new approach, "It's largely modeled after Federal Reserve-type supervision and I can't imagine anyone would question that kind of approach." She was right—few did. Swiss banking regulators are only now raising mandatory capital ratios above those permitted under Basel II.

One fair question to ask is how such regulation could have allowed Wall Street to employ so much more debt than the commercial banks. Part of the answer is that, instead of a fixed capital ratio standard, Basel II uses mathematical models crunching historical data to determine how risky an institution's assets are and how much capital it needs. For this reason, when the investment banks switched to Basel II in the middle of a housing boom, AAA-rated mortgage-backed securities appeared almost as safe as cash. Oops. The models allowed Wall Street to add too much leverage. By the same token, because risk models will now look back and see several awful years of default rates, they may force banks to be overly cautious.

News reports have played up a recent report by the Inspector General of the SEC criticizing the SEC's risk supervision under the 2004 rule change. The inspector also criticized the specific monitoring of Bear Stearns. But on the central question of whether the rules were enforced and applied correctly, the inspector's verdict is clear: "Bear Stearns was compliant with the [Consolidated Supervised Entities] program's capital and liquidity requirements."

We should also note that the SEC's net capital rules appear to have worked as they were originally intended throughout this crisis. Created in 1975, these regulations were explicitly to protect cash and securities in investor accounts. Sure, investment banks could fail, as Drexel Burnham Lambert did in 1990, but such failures could not be allowed to wipe out brokerage customers.

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In case a firm or an individual violates the obligation, there is the Securities Investor Protection Corporation (SIPC). According to the SIPC, individual customer accounts were never in danger at Bear Stearns. As for Lehman, the paperwork challenge will take time to resolve. Lehman's more than 600,000 accounts are roughly equal to the total that SIPC has had to manage in its entire history since 1970. But so far, the SIPC reports it is processing accounts as it always does, and customers are receiving their due.

As for the SEC, if commissioners took on a massive burden in 2004 without realizing they had signed up to safeguard the world's financial system, then they overreached. But they certainly did not "deregulate."

Also by Charles W. Calomiris:

Article in the *Wall Street Journal*

Most Pundits Are Wrong about the Bubble

October 18, 2008

It is grind-your-favorite-axe day on the network news shows. The financial crisis is all the fault of dreaded "deregulation," some pundits shout; others blame the "small government" mentality of the Bush administration and Republicans in Congress.

But haven't federal and state tax revenues been growing even faster than home prices in most places in the United States over the past eight years? Hasn't the problem with our government's fiscal affairs been enormous growth in spending and entitlements not seen since the days of Lyndon B. Johnson? Congressional Democrats—along with a surprising number of pork-barrel Republicans—demanded nonwar spending on a Great Society scale, and the president gave in to buy their votes for the war. . . .

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