Securitization and Financial Regulation: Pondering the New Normal[1]
Barry Eichengreen
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Although the credit crisis in the United States is still running, it is not too early to start thinking about the post-crisis financial world. There are basically two views of what the new normal will entail. One is that, as a result of the most serious financial crisis since the 1930s, we are headed back to the good old days of plain vanilla securitization. Investors have learned their lesson. They have lost their appetite for opaque, highly-engineered derivatives. Regulators and their political masters have similarly lost their tolerance for complex financial operations. The result will be a return to the days before derivatives, tranching, and originate to distribute.

The other view is that the new normal will be pretty much like the old normal. All this talk of the end of securitization is overblown. The advantages of slicing, dicing and repacking risks are simply too great to be sacrificed. Investment bankers, underwriters, and traders all have too much invested in the process. The Basel II reform of capital adequacy standards for banks will eliminate the worst excesses. The rating agencies will agree to codes of conduct and greater transparency. To the extent that there are still problems, regulators will deal with them by tightening up here and there. But, in the end, you can't put the toothpaste back in the tube. The new normal will be pretty much the same as the old normal.

For the last year I've been in the second camp. My view was grounded in two observations. First, serious regulatory changes, like those proposed under Treasury Secretary Henry Paulson's proposal for reorganizing financial regulation in the United States require the serious attention of the Congress. Unfortunately, serious attention, unlike partisan posturing, is not something of which the Congress is capable in a presidential election year. And once the election is over and there is a new Congress (along with a new president and new Treasury secretary), the urgency will be gone. The window of opportunity will have closed.

Second, the idea that the markets learn from experience is – how should I put it? – naive. Ten years from now they will be dominated by a new generation of bond traders who were still wet behind the ears in 2008. These individuals will have no first-hand knowledge of what will have been quaintly referred to in their college textbooks as "the subprime crisis." Almost certainly, as a result, the whole alphabet soup of complex derivative securities will be back.

On both grounds, then, I have been skeptical that there are prospects for meaningful change. But I am now coming around to the view that we are likely to see more extensive reform. Again, there are two reasons. First, what many people thought was a sharp but short crisis that had been brought to an end by the Bear Stearns rescue (if "rescue" is the right word) is turning into a long economic slowdown that will continue to be marked by negative credit events. There will be more bank failures. More hedge funds will go out of business. Monoline bond insurers will fail. We will be lucky if the United States begins putting these problems behind it before 2010. This will leave plenty of time for the Congress to turn its attention to regulatory reform after the election. For better or worse, the window of opportunity may be

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wider than previously thought

Second, the new regulatory environment is not something that will be decided by American politicians and officials acting on their own. What happens in Europe will be as important as what happens in the United States. European banks actually took more subprime-related losses than American banks. European politicians and officials have always been less enthusiastic about light-touch regulation. They will now do what they can to prevent another episode of financial excess like the one from which we are attempting to recover.

On what changes will American and European regulators agree? They are likely to start with the rating agencies. The European Union this month set up a registry for rating agencies as a first step toward tighter regulation. Charlie McCreevy, the EU Commissioner for the Internal Market, plans to revisit this issue after Europe's August holiday and lay down rules for the procedures the agencies should follow as a condition for allowing them to do business in Europe. We will see if he succeeds.

McCreevy's other goal is to encourage more competition in the rating industry. There is considerable merit to this idea whether or not you think it is important to have "a European rating agency." Standard & Poor's, Moody's and Fitch are an oligopoly. They don't face much danger of losing market share, much less franchise, when they fall down on the job, since there is basically no one else to turn to. The decision of the U.S. Securities and Exchange Commission to give an upstart rating agency, Egan-Jones, Nationally Recognized Statistical Rating Organization (NRSRO) status last December (so that its ratings can be used when setting capital requirements) was a useful first step in the direction of more competition. But only one step.

I also like the initiative by New York State Attorney General Andrew Cuomo to require rating agencies to charge fees for helping structure issues all through the process of preparing them for the market, and not just at the end, as a way of preventing issuers from shopping for ratings. I like the idea of SEC Chairman Christopher Cox to prevent the same analysts who advise issuers from also rating their bonds. There are also some more ambitious ideas out there about more fundamental reorganization of the industry. For example, it has been proposed to prevent rating agencies from advising issuers entirely and to abolish NRSRO status. But these radical changes are quite unlikely to be implemented.

We will see some extension of regulation, including capital regulation, to investment banks, a responsibility which the Fed and SEC are battling one another to secure. This will be a consequence of the Bear Stearns rescue, which taught regulators two things. First, that these institutions are too intimately connected with other financial institutions to be allowed fail. And, second, that they are extraordinarily highly leveraged. Commercial banks' assets may average 10 times their equity, but investment banks were holding, prior to the deleveraging precipitated by the crisis, assets equivalent to an incredible 24 times their equity capital. The regulators will now insist, in the interest of stability, on some reduction in investment banks' leverage.

This will mean lower investment bank profits and a more sedate investment banking environment generally. There has been enormous growth of investment bank portfolios in the last 20 years, reflecting the role of these institutions as financial innovators but also their skill in exploiting regulatory loopholes. So a smaller investment banking industry, insofar as this reflected less regulatory arbitrage, would not be a bad thing. In this one respect at least, we *are* likely to go back to the future.

Regulators will also attempt to calibrate capital requirements not just to the riskiness of a bank's assets but also to the riskiness of its funding. This is another lesson of the credit crisis – and of Northern Rock in particular. Fortunately, the Basel II capital adequacy revision already provides for this, at least in principle.

But this is not to say that Basel II will remain unchanged. The two foundation stones of Basel II are internal models of value-at-risk for big banks and credit ratings for the others. We now know that both foundations are faulty. The question is what to do. My recommendation has been to require banks to compute their capital requirements two ways: the high-tech way recommended by Basel II, and a low tech-way inspired by Basel I (maybe 12 per cent of unweighted assets), and then to require them to hold them to the higher of the two. I've been arguing this to my European friends, so I was gratified to see that the Swiss National Bank came out late last month for something along these lines. Admittedly, in doing so they were almost certainly more impressed by UBS's $35 billion of credit losses than by my arguments.

Monoline bond insurers like MBIA and Ambac will also play a reduced role in the future. The value of their guarantees depends on their credit ratings, and their credit ratings depend on the adequacy of their capitalization. As in the fable of the emperor's new clothes, we have discovered that these entities are inadequately capitalized relative to the riskiness of the instruments they guarantee. There is no way around this other than for regulators to require them to raise more capital and insure fewer bonds. This means that their services will become more expensive and bond insurance will be less prevalent.

In turn this will make it more difficult for fiscally weak municipalities to issue bonds. But, once again, this is not an entirely bad thing, for it will apply more pressure for those municipalities to get their fiscal houses in order. More expensive bond insurance will also make life more difficult for the repackagers of subprime mortgages. But that's not obviously a bad thing either. Ultimately, we may also see a rethinking of the regulations adopted in the United States in the late 1980s that prohibited multiline insurers from insuring municipal bonds and gave rise to this crazy monoline insurance industry in the first place.

That brings us finally to Fannie Mae and Freddie Mac, the other providers of guarantees. The crisis of these institutions is too recent for anyone to be able to realistically forecast its resolution. In my view, there is a very real possibility that the cost to the taxpayer of their bailout will be closer to $100 billion than the CBO's $25 billion best-guess estimate. Recall that Freddie and Fannie hold about $500 billion in subprime and Alt-A mortgages. Assume a loss rate of 20 per cent on these assets. You can do the arithmetic. It could happen.

As for subsequent reform, I know what I'd like to see: I'd like to see these institutions broken up. Breaking them up will mean that that they will no longer be too big to fail. It will mean that they can be meaningfully privatized. They will then not be recipients of implicit government guarantees, and they will not benefit from subsidized funding, encouraging them to lever up their balance sheets. At best, this will have to wait until the housing market recovers. And whether even then there will be the political will to undertake this is more than a bit dubious.

So I conclude where I started. It is not my view that the age of mass securitization is over and that we are about to go back to the 1950s. But I do think that the renovations that we are about to undertake will amount to more than just a new coat of paint.

Barry Eichengreen is George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley.