Insight

FCIC Report: What have we learned since?

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Shortly after the height of the financial crisis, as mandated by the Fraud Enforcement and Recovery Act of 2009, the Financial Crisis Inquiry Commission (FCIC) was formed and tasked with investigating and issuing a report on the causes of the crisis. Coming in at 633 pages, the report leads with the majority's opinion, followed by two separate dissenting discussions.

January 27 marked the 5th anniversary of the release of the FCIC's report. In those five years, we have learned a lot. We've learned what the report (and/or its dissenting opinions) got right, what subsequent financial reform got wrong, and what everyone may have totally missed. What follows is a short discussion of the good, the bad, and the ugly of lawmakers' responses to the crisis over the past five years.

The Good

Capital Requirements

Perhaps the best thing to come out of all the post-crisis regulations, stress tests, and life lessons were greater capital reserves for financial companies. Throughout the crisis, many of the banks that eventually failed were leveraged at ratios of 35 to 1 or greater. While profitable when the economy was doing well, these companies were extremely exposed to any market fluctuation. With that leverage, just a three percent drop in the value of a company's assets would make it technically insolvent. Add that to portfolios that also were highly concentrated in correlated housing assets, and a big part of the propagation mechanism for the disaster was in place.

Dodd-Frank's capital mandates sought to prevent this by requiring banks to hold minimum capital buffers at rates determined by the Fed. Currently JP Morgan is required the hold the highest amount of capital, at 4.5 percent of total assets, with the next seven largest institutions holding between 1 and 3.5 percent. These surcharges come at a cost: reduced lending activity, increased client fees, etc., but most can agree that the benefits from at least some increase in banks' capital cushions outweigh those costs.

Office of Credit Ratings

For one of the authors, the greatest (personal) lessons of the FCIC experience was the importance of the credit rating agencies. One might think that leading Wall Street firms, with large quantitative capabilities could and would do their own due diligence on the MBSs, CDOs, synthetic CDOs and other securities that became toxic. Not so. Instead, leading up to the crisis, credit rating agencies erroneously rated toxic mortgage-backed securities and their derivatives as safe investments, and markets priced them accordingly. Purchases of these products climbed steadily for several years through 2006, and, as a result, there was a steep decline in mortgage underwriting standards and a simultaneous spike in poorly-underwritten mortgages.

In response, Dodd-Frank created the Office of Credit Ratings within the SEC and required credit rating agencies

to explain in their reports any representations made to investors and how those representations differ from any representations made in similar analytical issuances. It also subjects credit rating agencies to liability under the Securities Act of 1933 and requires disclosures to the SEC not unlike those required of financial institutions.

Mortgage Relief Programs

"Bailouts" have become a toxic word. But passage of the Troubled Assets Relief Program (TARP) was a good policy move (although its execution left a lot to be desired). So was passing the Housing and Economic Recovery Act that permitted the federal government to keep Fannie Mae and Freddie Mac from collapse. This was a way to provide a *de facto* guarantee of trillions of agency debt held by sovereigns around the globe. And as a matter of economics, a large-scale program to reduce or eliminate negative equity in the residential housing sector would have had beneficial macroeconomic impacts. Unfortunately, the mere mention of it to CNBC's Rick Santelli incited an epic rant and launched the Tea Party movement.

In short, the "bailouts" in 2008 and 2009 in response to the crisis were good policy. Unfortunately, any mortgage fix that would have actually helped the economy wasn't (and probably still isn't) politically feasible. There are still miles to go in reforming the GSEs (and getting them out from under conservatorship), but it's safe to say that the bailouts were the right thing at the right time.

The Bad

Derivatives Rules

Non-credit derivatives did not substantially contribute to nor cause the financial crisis. Yet the regulation that followed cracked down on them as if they were the sole source the meltdown. Most often referred to as the "push out" rule, Dodd-Frank required banks to "push out" swaps and other derivatives to bank affiliates so as to not be traded directly by the bank. Not only does this complicate things for bank customers who seek a "one stop shop" for their financial needs, but it makes all of these banks more complex – one of the concerns Dodd-Frank specifically sought to curtail.

Further, Dodd-Frank levied strict rules on swap dealers and those that it deemed "major swap participants." Among them were margin requirements and fiduciary duties. Sure, margin requirements and fiduciary duties have their time and place, but for a product and its dealers that did not have a hand in the crisis, this batch of rules was a mistake.

Volcker Rule

In the world of really expensive solutions looking for problems, Volcker may very well lead the pack. Premised entirely on the false assumption that the crisis was caused by proprietary trading, Volcker is set to cost banks $4.3 billion according to the government's own estimates. Not only that, Volcker statutorily limits banks' ability to "make market" by buying, selling, and holding inventories in various securities. As a result, liquidity decreases and the cost of capital increases – two outcomes that were not only unintended but counterintuitive to the very purpose of financial reform.

New Disclosure Rules

A lack of certain disclosure requirements certainly didn't cause the crisis, yet the SEC still wrote 32 rules

costing over $11.9 billion because Dodd-Frank mandated that they do so. Take, for example, the Conflict Minerals provision which turned out to be the costliest of the bunch ($4.7 billion) but didn't even touch American companies, much less banks or anyone having anything to do with the credit bubble. Instead, thousands of miles away in the Democratic Republic of the Congo, a mining industry is being crippled as a result of Dodd-Frank's requirement that companies disclose whether they are receiving any "conflict minerals" – a designation made on a case-by-case basis by the International Conference on the Great Lakes Region.

In response, the Congolese government shut down the entire mining industry in 2010 before proposing a certification process to assure U.S. companies that the minerals aren't coming from conflict zones. As of 2011, only 11 of more than 900 mines in South Kivu, Congo, met Dodd-Frank's standards, and the more than 11 million people who were employed in the mines are forced to find work elsewhere – oftentimes with an armed militia.

The Ugly

Orderly Liquidation Authority/ TBTF

Proponents of Dodd-Frank's overreaching regulatory authority argued that big banks were too big and caused the financial crisis. They suggested that banks should not be allowed to become Too Big To Fail (TBTF), but, instead, should be treated like "any other company" and be allowed to fail and go through bankruptcy proceedings. (Notice, however, that TBTF is not a failure of the private sector. It stems from risk-averse policymakers being unwilling to do the right thing.) However, once the rules were implemented, they did just the opposite. Banks have gotten bigger, and "Too Big To Fail" has become part of the law. Banks now even have their own way of shutting down through Orderly Liquidation Authority (OLA) (another gift from Dodd-Frank) and don't have to go through bankruptcy proceedings like "any other company." In fact, OLA allows for future AIG-style bailouts in which the creditors and counterparties of a failed Systemically Important Financial Institution (SIFI) are made whole if regulators determine that such assistance is necessary to contain financial contagion.

FSOC

Dodd-Frank created the Financial Stability Oversight Council (FSOC) which, among other things, is tasked with designating companies as SIFIs. Unfortunately for those companies and their customers these designations can be slapped on companies that pose no discernible systemic risk to the U.S. economy, like insurance companies MetLife and Prudential. Yet they are being subjected to intrusive, unnecessary regulation, drying up capital for infrastructure projects and harming investors and policy holders.

Nothing Done About Fannie/Freddie

The ugliest of all the uglies is the absence of action on a core part of the actual causes of the crisis: Fannie Mae and Freddie Mac (the GSEs). Not only does Dodd-Frank fail to reform the GSEs, it specifically exempts them from OLA to ensure, as Barney Frank said, that the costs are "borne by taxpayers" and not the banks. And the bailout of the GSE's, which was in fact "borne by taxpayers," was the biggest bailout in history – more than AIG and General Motors and all the big banks combined. Further, now five years after Dodd-Frank, the GSEs are still under conservatorship on the government dole and are lapsing back into their past habits of underpricing risk and purchasing low-downpayment mortgages that fueled the last financial crisis.