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Who Dares Oppose a Boom

By David Merkel

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AT THE VERY HEART OF FINANCIAL REGULATORY REFORM, an error was made at the very beginning. As is common in American culture, the assumption was made that our laws and regulations were inadequate, rather than existing laws and regulations were inadequately enforced. As such, the law that was eventually passed largely strengthened the strictures against the crimes that happened.

But, the same regulators were left in place. Almost no one was fired for the incompetence demonstrated in not using the regulations that already existed for preventing shoddy loan underwriting. The SEC had the right to set capital ratios at 12 to 1, but waived that right and allowed the investment banks to be unlimited in their leverage. The GSEs took far too much credit risk, but who, if anyone, was fired for allowing them to do so? Or, who was fired for doing so?

The trouble is this: during boom times, it is virtually impossible to get regulators to oppose politicians who are being lobbied by financial services organizations when they are making gobs of money, and it all seems riskless, as the bubble expands. This is endemic to human nature; it is politically impossible to oppose booms. I for one wrote extensively about the coming housing bust, but all I received was derision. I wrote about the blowup coming in subprime residential mortgage bonds, but all I got was a yawn.

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So, unless we get a new set of regulators that are willing to be junkyard dogs, I don't care what laws we put in place. Laws are only as good as those that are willing to enforce them.

PROBLEMS WITH THE FINANCIAL REGULATORY REFORM BILL

Aside from a lack of change in the regulatory apparatus and personnel, my biggest difficulty with financial regulatory reform bill was a lack of change dealing with risk-based liquidity. We don't get runs on banks because of the insurance from the FDIC. But banks often find themselves facing a run if they use a lot of repo funding. Funding long-term assets short term is a recipe for disaster. The bill made no effective change with respect to this.

And though there will be higher levels of capital required of banks, which is good, there was not enough thought given to the riskiness of assets and how much capital they require. Basel III basically kept the same structure as Basel II, but did not make significant corrections to the differences in risk regarding assets. Further, they still allow companies to evaluate their own risks, rather than having a conservative and standardized approach for evaluating risk.

And to the degree that Americans believe that the financial regulatory reform bill will it prove the situation, it has given them a false sense of security. And that could be the worst problem of all.

CREATING AN EARLY WARNING SYSTEM

There is great demand for an early warning system that could highlight whether systemic risk is getting too high for the financial economy overall, or whether risk is getting too high for any given subclass of financial risks in the economy. I am happy to say that creating an early warning system would be easy. Consider the differences between fresh produce and financial assets:

- **Time horizon**—fresh produce is perishable, whereas most risky assets are long-dated, or in the case of equities, have indefinite lives.
- **Ease of creation**—new securities can be created easily, but farming takes time and effort.
- **Excess supply vs. excess demand**—with a bumper crop, there is excess supply, and the supply is typically high quality. Now to induce buyers to buy more than they usually do, the price must be low. With financial assets, demand drives the process. Collateralized debt obligations were profitable to create, and that led to a bid for risky debt instruments. The same was true for many structured products. The demand for yield, disregarding safety, created a lot of risky debt and derivatives.

- **Low supply vs. low demand**—with a bad crop, there is inadequate supply, and the supply is typically low quality. Prices are high because of scarcity. With financial assets, low demand makes the process freeze. What few deals are getting done are probably good ones. Same for commercial and residential mortgage lending. Only the best deals are getting done.

Fresh produce is what it is, a perishable commodity, where quantity and quality are positively correlated, and pricing is negatively correlated. Financial assets don't perish rapidly, quantity and quality are negatively correlated, and pricing is often positively correlated to the quantity of assets issued, since the demand for assets varies more than the supply. Whereas, with fresh produce, the supply varies more than the demand.

When I was a corporate bond manager, one of the first things that I learned was that when issuance is heavy, typically future performance will be bad. Whenever there is high growth in debt in any sector of the economy, it is usually a sign that a mania is going on. But it is very hard for a corporate bond manager who is benchmarked to an index to underweight the hot sector.

It is also very hard for a loan underwriter at a bank to stay conservative when he is being pushed for volume growth from his superiors, and most of his competitors are being liberal as anything. It is hard for anyone in the financial services arena to not follow the prevailing tendency to lower credit standards during a boom.

So if I were to give advice to the new office studying systemic risk, I would give this one very simple bit of advice: look for the sector where debt is growing faster than what is ordinary. It's that simple.

If they want to get a little more complex, I would tell them this: when a boom begins, typically the assets in question are fairly valued, and are reasonably financed. There is also positive cash flow from buying the asset and financing it ordinarily. But as the boom progresses, it becomes harder to get positive cash flow from buying the asset and financing it, because the asset price has risen. At this point, a

compromise is made. The buyer of the asset will use more debt and less equity, and/or, he will shorten the terms of the lending, buying a long-term asset, but financing it short-term.

Near the end of the boom, there is no positive short-term cash flow to be found, and the continuing rise in asset prices has momentum. Some economic players become willing to buy the asset in question at prices so high that they suffer negative cash flow. They must feed the asset in order to hold it.

It is at that point that bubbles typically pop, because the resources necessary to finance the bubble exceed the cash flows that the assets can generate. And so I would say to the new office studying systemic risk that they should look for situations where people are relying on capital gains in order to make money. Anytime an arbitrage goes negative, it is a red flag.

The new financial regulatory reform bill did create an office for analyzing systemic risk, and created a council that supposedly will manage it. Would it be smart to concentrate the efforts into one leader who will both analyze and control systemic risk?

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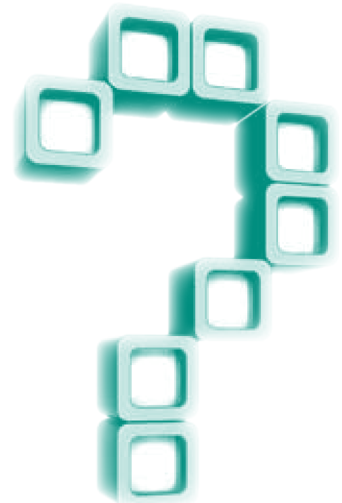
For better or worse, Americans tend to look for one strong leader who will lead them out of their problems. Anyone who might be chief risk officer of the United States, would have to have control over the Federal Reserve, which creates most of the systemic risk that we have through its monetary policy, and its lack of leadership in overseeing the banks. I don't think it's politically possible to put a risk manager in charge of the Fed, though it might be desirable to do so. The Federal Reserve always gets what it wants.

SUMMARY

I don't have a lot of hope that the current financial regulatory reform bill will improve matters much. The same regulators are in place, who did not use the laws that they had available to them to prevent the last crisis. Systemic risk can be prevented if regulators focus on areas where debt is growing dramatically, and where cash flow from buying and borrowing is diminishing dramatically. But it is intensely difficult to stand in the way of a boom, and tell everyone "Stop!" The politics just don't favor it.

Finally, it would be difficult to create a chief risk officer of the United States. The current politics do not favor creating such a strong office, because it would have to control the Federal Reserve. ■



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