Aspera Bulletin

Intelligent, Independent Investment Management

Chocolate And Beer – Part 1

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I admit it. The title is a little misleading. I'm actually going to discuss financial market regulation, but I wanted you to at least get past the title. Regulation is the dentist office of the financial world – nobody really wants to go there. In the mid-90's, I was an MBA student at the University of Chicago. They have a bidding system for classes, and I was saving a bunch of points to bid on Merton Miller's class. He was a Nobel Prize winner, and he only taught one class each year, so I was sure the class would cost me. The topic of the class was financial regulation, but he was a Nobel Prize winner! Amazingly, the class didn't cost me a point since the class didn't fill up – only about 20 of us signed up. So, I know that this isn't the most exciting topic. If a Nobel Prize winner can't fill a small class, I realize I probably lost most of you by the second sentence. No matter. I'll soldier on if for no other reason than to spare my wife.

The chatter about the failure of the free market and capitalism has been steadily increasing as has the call for increased financial market regulation. This is hardly surprising given the news of the past six months: credit markets seizing up, rising foreclosure rates, the failure of the rating agencies, the collapse of Bear Stearns and a number of hedge funds, mortgage origination and appraisal improprieties, tumult in the "safe" muni market, etc. Furthermore, it's an election year and you'd better show leadership and be full of ideas if you're running for President. Time to put the baby down and draft some legislation.

So it's no surprise that the call for increased regulation is on the rise, but I find it a bit ironic. The current credit bubble was caused, in some part, by regulation itself. Let's start with the Federal Reserve, arguably the most prominent regulator of the financial system. Under Greenspan, the Fed rarely hesitated to cut rates in an attempt to forestall any whiff of a slowdown or financial dislocation. This came to be known as the Greenspan Put. Greenspan repeatedly and effectively placed a floor under the markets by lowering interest rates and increasing the money supply at any hint of instability (think Long-Term Capital Management and the tech bubble collapse). This encouraged risky behavior.

The thinking was straightforward. If you take a big risk and you're right, you win. If you take a big risk and you're wrong, the Fed bails you out. It didn't take long for folks to figure out that it paid to take risk. The Fed was distorting the real relationship between risk and reward and causing an ever greater misallocation of resources as normal market signals were subverted. This encouraged an increasing amount of risk to be taken with each cycle of easing.

The low interest rates and increased money supply ultimately found its way to the housing market, resulting in the biggest housing (and credit) bubble we've ever seen. I'm not saying the Fed is singularly responsible for causing the bubble, but it did play an important part.

Another example of the role that regulatory interference has played in our current crisis is the effective oligopoly that the SEC (a regulator) has given to a handful of credit-rating agencies. These credit-rating agencies essentially faced no competition, and they made their money by charging fees to the very companies they were rating – an obvious conflict of interest. It's not exactly clear to me why the SEC should even be involved in controlling the entry of new competitors. Had a free market allowed for the entry of new competitors we would have been much more likely to have seen some evolution in the relationship and incentive structure between the credit agencies, the firms they evaluate, and the investors who ultimately purchase the securities.

We would also have been more likely to have seen some evolution in the risk models that somehow managed to bestow AAA ratings upon the Frankensteinian brew of mortgage-crapped securities known as collateralized debt obligations (CDOs). Eventually, people will learn that 1+1 does not equal 3. Let's not forget that these are the same rating agencies that also managed to miss the fact that Enron, Worldcom, and Adelphia were frauds. So our regulators protected a few credit-rating firms (which had just recently shown their tremendous failings a few years prior) from contending with new competition. We need more of that?

Don't forget about Fannie Mae and Freddie Mac. As the nation's primary buyers and guarantors of mortgages, they had a front row seat to the excesses in the real estate market. Importantly, these two quasi-governmental agencies are highly regulated by the Office of Federal Housing Enterprise Oversight (OFHEO). According to their website, OFHEO's mission is to "promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac. OFHEO works to ensure the capital adequacy and financial safety and soundness of two housing government-sponsored enterprises (GSEs)…" Wow. Ensuring the safety and soundness? Ensure capital adequacy? In light of Freddie and Fannie's deteriorating balance sheet and capital position, OFHEO hasn't been terribly effective. We need more of this?

Let's not kid ourselves. There was plenty of regulation before this latest crisis. Yes, it's true that the financial institutions were employing strategies and creating securities to move assets off-balance sheet and out of the purview of the regulators, but everyone knew that they were doing this – including the regulators. Where were all the warnings from the regulators about this? Where were the warnings from the regulators about the markets/firms/securities they did oversee?

The fact is that all parties, including the regulators, knew what was going on, but everyone chose to ignore it since it seemed to be working. When it comes to derivatives, Greenspan himself had said "these instruments enhance the ability to differentiate risk and allocate it to those investors most able and willing to take it." So, seriously, had the regulators been in charge of regulating even these non-regulated instruments would anything have played out differently? The Chief Regulator himself was a fan!

The objective of this article is simply to look at just a few examples of the role the regulators have played in the current crisis. My main point is that we had plenty of regulation already, and it failed. Depending on how you look at it, it appears the regulators were either asleep at the switch, accomplices, or negligent. They failed to forestall the current crisis, and, in fact, pursued polices that (at a minimum) exacerbated it. Despite this, we're hearing calls for more regulation. We're hearing that existing regulation failed because there wasn't enough of it, and it wasn't structured properly, and it didn't have enough bite. Do we really think that more government bureaucrats are the answer? It might help the faltering national employment figures, but is it really the solution? Don't these folks get something like 150 days off a year? No wonder they've been so ineffective.

We're also hearing that the free market failed. The fact is that we were never operating in a free market in the first place. A truly free market isn't encumbered by all of these regulations. A truly free market doesn't have an elite body of 12 setting short-term interest rates. A truly free market doesn't use taxpayer dollars to bail out banks which made bad bets or homeowners who took on more of a mortgage than they could handle. A truly free market doesn't struggle with the issue of moral hazard because it lets the losers fail. I know this may sound crazy given the current fear and fervor in the markets and political arena, but here's my prescription – less regulation and more accountability. I'll follow up on this in Part 2.

Best,

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President
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