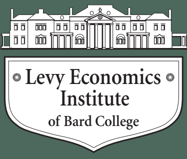

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Reforms Without Politicians

What We Can Do Today to Straighten Out Financial Markets

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Congress is currently debating new regulations for financial institutions in an effort to avoid a repeat of the recent crisis that brought the banking system to the brink. Some of those proposed changes would be valuable. But what nobody seems to have noticed is that the government already has the power to address some of the most important factors that contributed to the crisis. Today, right now, Washington could change a few key rules and prevent a repeat of the rampant speculation and possible fraud that led to so much trouble this last time around.

How? Federal regulations governing capital markets are based on the principle that plenty of sunlight is healthy. The government thus requires investment companies to register the securities they issue and disclose all relevant information about them—information that is then made publicly available. Yet the mortgage-backed securities and collateralized debt obligations at the center of the crisis were exempt from these requirements. As a result, investors couldn't examine the mortgages that provided the raw material for these structured vehicles. Credit rating agencies were also unable to access information on the underlying mortgages, even though they were providing ratings for the securities into which the mortgages were bundled.

Did this situation arise from fraud or malfeasance? Actually, it was all perfectly legal, courtesy of interpretative decisions by federal regulatory agencies that resulted in a couple of gigantic loopholes.

The standard securitization structure takes the form of a trust or "special purpose entity"—for all intents and purposes, an investment company. Such companies are normally subject to registration under the 1940 Investment Companies Act. However, the Securities and Exchange Commission (SEC) has ruled (3a-7) that a special purpose entity that issues fixed-income or other securities that entitle their holders to receive payments based primarily on the cash flow from eligible assets is not an investment company, and is thus exempt from registration. Many of these entities are part of what has come to be known as the "shadow" banking system, since they tend to fund themselves with liabilities that are of shorter term than their assets.

In addition, securities are normally registered with the SEC and subject to its reporting requirements. However, SEC Rule 144 provides for "restricted" private placement securities that are exempt from registration when sold to qualified institutional buyers. The 3a-7 exemption also provides that these unregistered securities, at the time of their initial sale, be assigned to one of the four highest categories of long-term debt by at least one nationally recognized rating agency. Since the issuer does not have to file reports on the securities' performance, all due diligence is left to the rating agencies—which do not have the same clear-cut incentives as investors, and which in the recent case did not have access to information about the underlying mortgages. As a result of Rules 3a-7 and 144, an unregistered investment company can issue unregistered securities to qualified investors without providing any public information, a situation completely contrary to the disclosure tradition of the American regulatory system. In addition, these rules allow the creation of liquidity that lies outside the control of the Federal Reserve, and a class of investment company that is entirely dependent on private information, counterparty regulation, and the presumed efficiency of the rating agencies.

Eliminating these two rules would remove the worst abuses of the mortgage market and needs no congressional approval. It would restore the presumption of full information as the best way to sanitize financial markets. The SEC is considering reforms to these exemptions. They should simply be removed.

But that's not all. To get the favorable ratings that allowed the exemptions, issuers of these securities obtained guarantees from insurance companies or by purchasing credit default swaps. In both cases, lack of information and reliance on rating agencies meant that the guaranteeing institutions were insufficiently capitalized. Full disclosure would have exposed the magnitude of this problem.

Credit default swaps provided the basis for another form of unregistered entity: synthetic collateralized debt obligations. To be viable, these structures required the purchasers of credit insurance to have no "insurable interest" in the underlying securities. There was no recognized mechanism for determining collateral or risk margins on these swaps. The value of the underlying securities can't even be marked properly to market when they are exempt from both registration and trading on regulated exchanges.

Requiring either an insurable interest or a method for meeting the full maintenance margin would remove the speculative element from these structured securities by allowing investors to see what was going on underneath. Requiring an insurable interest would simply involve classifying and regulating these contracts as insurance—which is what they are. Margin requirements could be maintained by requiring collateral on both sides of the swap, as in a total return swap, with the change in principal value incorporated in the return difference each day.

These very simple steps would have cast a light on the murky financial doings that got us into the recent crisis, exposing the risks (and possibly the fraud) to the cleansing action of the markets. Justice may be blind, but investors shouldn't be.

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