Daniel Alpert Managing Director • dalpert@westwoodcapital.com • +1-212-953-6448

The Re-Regulation of the Financial Services Sector

Highlights

- Apparently forgetting that they failed to exercise proper oversight of financial institutions for much of this decade, members of Congress and regulators have been clamoring for new regulatory regimes and bureaucracies.
- New regulation isn't nearly as critical as stringent enforcement of existing capital adequacy rules.
- Reliance on evaluations by credit rating agencies led institutions and regulators to de-emphasize internal risk management and diligence.
- The final repeal of the Glass-Steagall Act, in 1999, eliminated conflict-of-interest safeguards that may have prevented aspects of the current crisis.
- We don't need to reinvent the wheel, as much as realign our wobbly regulatory wheels toward a smoother road ahead.

Overview

With much hand-wringing and chest-thumping, legislators, members of the administration and central bankers have been making daily pronouncements on the failures of banking and securities regulation, in anticipation of a still unknowable future. As we await first-quarter financial results, accompanied by yet another round of asset write-downs and credit impairments, it's obvious the mortgage and lending disaster has morphed into a full-scale banking and financial services emergency that requires swift action to prevent a recurrence.

The situation stems not from a lack of regulation, in contrast with the anything-goes mortgage lending industry, but from a failure to rigorously apply, enforce and/or maintain regulatory safeguards developed on the heels of past crises. As well-meaning pundits call for new regulatory frameworks, and the laissez faire crowd even promotes greater reliance on industry self-regulation, we should review how preexisting regulations were not applied as originally intended. The current climate can be traced to:

- Existing regulatory bodies' failure to proactively enforce capital adequacy rules applicable to banks and investment banks;

- Toleration of a regulatory and self-regulatory environment that permitted blind reliance on valuation and statistical credit analyses by private-sector firms that failed to operate on a truly arms-length basis; and

- Elimination of basic conflict-of-interest safeguards encompassed in the regulatory rubric of the Depression-era Glass-Steagall Banking Act, repealed in 1999.

Overleveraged Financial Institutions

Banks and investment banks have been operating at stratospherically high levels of financial leverage (the ratio of debt-to-shareholders' equity). With large, heavily regulated commercial banks, significant debt was hidden in "off-balance-sheet," special-purpose entities (à la Enron), which turn out to be not so off-balance-sheet in times of crisis. Shareholders' equity in commercial banks (and, to a lesser extent, investment banks) is also inflated by accounting entries for goodwill and other intangible assets that offer no real value when the going gets tough.

Such is the case in the present crisis. Large commercial and investment banks, when reckoned without regard to intangible assets, and after covering debts of supposedly off-balance-sheet entities ultimately assumed by the commercial banks—are operating at leverage ratios in the neighborhood of $33 of debt for every $1 of equity. With this debt ratio, a reduction of just over 3% in assets' value wipes out a bank's entire equity.

In good times, with rising asset values, this doesn't matter. In fact, one can argue that book equity value is often understated in healthier economic times, when asset values increase but are carried on the books at the lower of amortized cost or net realizable value. But as we are seeing now, such leverage has a whipsaw effect in bad times. Losing only a small amount of asset value is catastrophic to the entire banking system—and right now, we are experiencing far more than a small loss in asset values.

We have an internationally accepted set of standards expressly designed to limit leverage of commercial banks and insolvency risks during crises: the so-called Basel I and Basel II Accords, named for the Swiss city where the world's banking clearinghouse, the Bank for International Settlements (BIS), is based. Originally promulgated in 1988 and extensively revised in 2004, the Accords provide, in substance, for the weighting and scoring of every bank's assets, based on credit and other risks. This determines how much capital a bank must maintain. Failure to sustain sufficient capital would make a bank ineligible to transact business through the BIS, effectively cutting it off from international trade. Accordingly, all G10 and many other countries have adopted the Accords in their own regulatory frameworks. Similar, but less stringent, risk-based capital requirements exist for U.S. and international investment banking sectors.

There are two problems with enforcing the generally highly regarded principles and methodologies of the original Basel Accords (and its antecedents in U.S. regulatory frameworks). First, the Accords were "improved upon" (read: weakened) by Basel II, which made it easier for very large, sophisticated banking groups to increase leverage and assume greater risks. Large banks insisted these changes be competitive with investment banks' standards. Second, methods of weighting the risk of the increasingly complex assets banks held became more suspect over the course of this decade. This made banks extremely susceptible to losses arising from what turned out to be far more risky assets than anticipated (or what they told regulators).

Outsourcing of Responsibility

If you're in the business of walking a high wire without a net, it's best to avoid drinking spiked punch before you ascend the ladder. Commercial and investment banks (and their regulators) "drank the punch" with respect to the credit worthiness and value of an entire range of loan and derivative assets, while walking a tightrope anchored to shaky towers of massive leverage. How could such copious brainpower in the financial services establishment fall off the wire? In most cases, the culprit was outsourcing. Simply put, banks and their regulators abrogated their credit-weighting function to assessments submitted by the three major statistical credit-rating agencies. These agencies received substantial fees for their services and were hired and paid by the banks. The rating agencies' ability to service their "clients" (the banks, not the investors in the securities they were rating) determined the amount of forthcoming business. Not surprisingly, other than achieving Nationally Recognized Statistical Rating Organization ("NRSRO") status, rating agency activities and methodologies are completely unregulated. In fact, the Credit Rating Agency Reform Act of 2006 specifically barred the SEC from regulating ratings methodologies.

The rating agencies embarked on a treacherous path when servicing their clients. They often relied on mortgage performance models from earlier decades, ignoring fundamental changes as housing prices inflated at unprecedented levels (74% nationally from 2000 to 2006). Cheap, shoddily originated loans, which the rating agencies had enabled, were sold as mortgage-backed securities. One must ask: How did the rating agencies' best and brightest minds fail to comprehend the relationship between cheap and "creative" financing and asset inflation to unsustainable levels? But as long as banks expected favorable ratings, why rock the boat? In fact, when housing inflation outstripped the justification that historical mortgage performance models provided, the rating agencies amended their models in 2005 to assume a new paradigm of continuous home price appreciation.

The rating agencies also relied on supportive real estate appraisals to justify mortgages. When considering market value of real estate, appraisers are generally required to factor in the value of properties based on comparable sales, the income they would produce if rented and the cost of replacing existing homes with newly constructed ones. They must then reconcile any differences among these three classic valuation methods. During the housing bubble, however, home prices completely disconnected from both rental values and replacement costs and most appraisals didn't even cover comparisons to the rental market at all . If they had, appraisers couldn't possibly reconcile income and replacement cost derived values with prevailing sales prices. Instead, they merely concluded that recent sales were the only valid indicators of fair market value, and they ignored the impact of demonstrably uneconomic creative financing. Meanwhile, no one at the rating agencies, banks or regulatory agencies uttered a word of concern. And as long as housing kept appreciating, borrowers were able to refinance themselves out of trouble – often repeatedly.

Shards of Shattered Glass

Finally, the post-Great Depression regulatory environment was turned on its ear with the repeal of the Glass-Steagall Act in 1999—specifically, the Act's separation of commercial and investment banking. Commercial banking companies gained the ability to underwrite stock and debt issuance, as well as conduct business formerly restricted to investment banks. Accordingly, the ability to have banks provide leverage (including and beyond traditional margin leverage, which primarily restricts borrowing against securities by individual investors) to the holders (often hedge funds and other entities in the shadow banking community) of the same shares and bonds their underwriting divisions were marketing opened the door to conflicts of interest, market manipulation and "irrational exuberance" the Act was designed to prevent in the first place. That this ultimately took the form of the leveraged loan business—in which banks provided enormous leverage to take entire public companies private by the boatload—was a natural derivative of the end of the separation of commercial and investment banking.

The re-joining of the commercial and investment banking function also brought investment banks into the direct-lending business, using their own and their clients' capital. This regulatory freedom had been a much-cherished goal in the commercial banking establishment for decades. As a result, what is almost certain to be the greatest financial dislocation since the Great Depression occurred during the first part of the decade immediately following the repeal of regulation that had served the country well since the fallout of the 1920s.

Conclusion

While others call for new regulatory institutions (or streamlining of existing ones), it is far more important and relevant to consider:

- The enforcement of existing regulation;
- The imperative of banks and regulators making their own credit decisions, rather than allowing conflicted parties to do so for them; and
- The reinstitution of restrictions on activities that lead to market behavior that creates over-leverage and overvaluation crises.

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Daniel Alpert is a Managing Director and Founding Partner of the New York investment bank Westwood Capital, LLC, and its affiliates. He is a frequent commentator on the housing and credit crises on the CNBC and Bloomberg networks, as well as in leading periodicals.