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A comprehensive solution to combustible markets

By Barney Frank | November 11, 2009

MANY MARKET and regulatory failures led to the collapse of the nation's financial markets last year. That collapse has led to a steep and painful recession and placed extraordinary burdens on working families. In response, the House Financial Services Committee, which I chair, is crafting a series of measures that will produce a comprehensive response by, among other things, regulating derivatives, ensuring proper mortgage lending, and making sure taxpayers never again have to take responsibility for reckless and irresponsible business decisions.

In many ways, AIG represents the poster child for the combination of reckless behavior and failed oversight, and thus gives us a window through which to look at the impact of the committee's response.

AIG's collapse was precipitated by excessive risk-taking in the unregulated and opaque derivatives markets - in particular, selling credit default swaps that were not backed by adequate capital. Consequently when AIG's credit rating was downgraded, it could not meet its collateral obligations.

If legislation recently passed by the Financial Services Committee had been in effect, derivative dealers such as AIG would have been regulated and the threat it posed to the financial system would never have been able to develop. The legislation subjects all swap dealers and major market participants to regulation and oversight, including capital and margin requirements. AIG would have been forced to post collateral to secure its exposure as well as to report all of its transactions to regulators.

At AIG, these risks were largely taken by a subsidiary of a financial services holding company that was not subject to comprehensive federal oversight. Legislation currently being considered by the committee will close that regulatory gap and subject all such holding companies to strong and comprehensive regulation.

Many of the credit default swaps issued by AIG were based on portfolios of subprime mortgages that were packaged into securities and sold around the world. Many of those mortgages were made by un- or lightly regulated mortgage companies that because they never intended to hold them used weak underwriting standards, resulting in a wave of defaults that brought down AIG and drove the financial system to the brink of collapse.

Legislation passed earlier in the year by the House - that we will incorporate into the final reform package - addresses this failure in two important ways. First, all mortgage lenders for the first time will be subject to high national standards, so that the industry can no longer give someone a loan who cannot afford to pay it back. Second, since the ability to bundle mortgages and sell them as securities encouraged this pattern of poor lending habits, no lender will be able to sell 100 percent of what they lend. They will be required to hold a share of each mortgage, thus maintaining their own exposure to the risk they have created.

Adding to the breakdown, many of those securities carried inappropriately high investment grade ratings issued by the credit rating agencies. The committee has responded by passing agency reforms that do two major things. It strengthens the regulation of the agencies to prevent any conflicts of interest and clarifies the liability standard to which they are subject; it also removes the mandatory use of those ratings from many federal statutes to limit the reliance on ratings by investors and encourage independent due diligence.

Too often, employees were compensated in a fashion that encouraged them to take inappropriate and excessive risks. Legislation drafted by the Financial Services Committee and passed by the House instructs all financial regulators to prohibit such compensation structures.

Taxpayers had to provide over \$130 billion to prop up AIG when it became clear that its failure would cause catastrophic damage to our entire financial system.

The government lacked any tool that would have allowed it to step in and shut down AIG in a fashion that would have minimized that damage and avoided the “too big to fail” problem. But legislation being considered would create a resolution process to manage the orderly dissolution of any troubled financial firm whose disorderly failure in bankruptcy would create systemic risk - thus ending the “too big to fail” problem.

As the example of AIG makes clear, there was no single cause leading to the collapse of the financial market. Neither can there be a single silver bullet solution. But the Financial Services Committee’s response, if enacted, would ensure that taxpayers will never again be called on to take responsibility for a firm’s terrible business decisions.

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