The Centre for International Governance Innovation

Domestic and International Regulatory Responses to the Subprime Crisis

David Andrew Singer

This paper was presented at the CIGI Workshop "Crisis and Response: Whither International Financial Regulation?" on September 26-27, 2008. The paper has not undergone the editorial review accorded official CIGI publications.

On July 11, 2008, California-based IndyMac Bank collapsed. Press reports of long queues of panicked depositors at IndyMac's branches were reminiscent of the rampant bank failures of the 1980s. Indeed, the press was quick to draw comparisons to the collapse of Continental Illinois in 1984, which—until the recent collapse of Washington Mutual—had the dubious honor of being the largest bank failure in U.S. history. But the Continental fiasco led almost immediately to a substantial domestic regulatory overhaul and solidified U.S. support for an international capital adequacy standard for commercial banks. Will the current crisis prompt another round of domestic and international rule-making?

This brief essay makes three related points. First, today's financial crisis is still at an early stage in terms of triggering a response from regulators. Comparisons with earlier bouts of instability are premature and potentially misleading. I make this point with a brief sketch of the U.S. banking crisis in the 1980s, in which regulators faced clear incentives for international cooperation. Such incentives have not yet emerged for the present financial crisis. Second, the existing international regulatory bodies—including the Basel Committee, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), and the Joint Forum—are currently reacting to the financial crisis in a mostly cursory way within pre-existing international agreements. The creation of new international financial regulation is unlikely in the near future, even if the financial crisis worsens. I highlight a few reasons for this claim, including the myriad proximate and underlying causes of the crisis, the fragmentation of domestic financial regulation in the U.S., and the lack of urgency felt by U.S. regulators for an international response. Third and finally, the most significant regulatory response to the financial crisis may be domestic: Treasury Secretary Henry Paulson has recommended the organizational consolidation of U.S. financial regulation, including the dismantling of the Office of Thrift Supervision and the creation of a federal insurance regulatory agency. The consolidation of U.S. regulatory agencies might facilitate international regulatory harmonization in the long term simply by reducing the transaction costs of international negotiation and clarifying agency accountability.

The Subprime Crisis vs. The 1980s

Today's financial crisis has triggered some of the largest bank failures in U.S. history, including IndyMac and Washington Mutual, as well as substantial instability in European banking markets. Prominent economists have publicly predicted more (and larger) bank failures in the coming months in the wake of the housing market collapse, and the U.S. Federal Deposit Insurance Corporation (FDIC) has made arrangements with the Treasury to borrow money to shore up its insurance fund. The crisis may indeed get much worse; as of this writing, the FDIC has identified more than 100 banks on its "troubled bank" list, and European regulators—including those in Belgium and the UK—are struggling to contain the fallout of the crisis in their own domestic markets.[1]

In the recent past, bank instability in the U.S. and the U.K. prompted both countries to press for new international financial regulation. A quick review of the 1980s may help to shed light on the prospects for a similar international response to the subprime crisis. For this period, I limit my focus to commercial banks and their regulators, rather than savings-and-loan institutions which were peripheral to the development of international standards.[2] I return to the fragmentation of U.S. regulation later in the essay.

---

[1] See Reinhart and Rogoff 2008 and Wade 2008 for analyses of the magnitude of the crisis compared to prior crises.

[2] During the negotiations over the Basel Accord in the 1980s, the now-defunct Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation (the equivalent of the FDIC for S&Ls) did not have a seat at the bargaining

In the U.S. in 1982—arguably the beginning of the 1980s banking crisis—42 commercial banks failed, resulting in FDIC disbursements totaling $2.3 billion.[3] The number of bank failures and the resulting FDIC disbursements increased dramatically throughout the rest of the decade (see Table 1). (Note that these figures do not include the hundreds of savings-and-loan institutions that collapsed during this period, because they were insured by the now-defunct FSLIC.)

Table 1: U.S. Commercial Bank Failures and FDIC Disbursements, 1980-1994

	Bank Failures	FDIC Disbursements ($B)
1980	11	0.15
1981	10	0.89
1982	42	2.28
1983	48	3.81
1984	80	7.70
1985	120	2.92
1986	145	4.79
1987	203	5.04
1988	280	12.16
1989	207	11.45
1990	169	10.82
1991	127	21.41
1992	122	14.08
1993	41	1.80
1994	13	1.22

Source: FDIC 1998; see also Singer 2007.

Domestic financial regulators responded relatively quickly as banks began to falter.[4] Capital adequacy requirements were first tightened in 1981 and then again in 1983. When Continental Illinois collapsed in 1984, Congress did not hesitate to place blame on the Federal Reserve and (especially) the Office of the Comptroller of the Currency (OCC). In response, the two regulators, along with the FDIC, imposed a new minimum capital ratio for banks in 1984-5. But obviously the regulators' actions had little effect on the tide of bank failures, as shown in Table 1. Indeed, more commercial banks failed in the 1985-87 period than in the prior 30 years combined. By the mid-1980s, regulators felt extraordinary pressure to tighten regulations further. But, as I have noted elsewhere, regulators also faced a rising competitive threat from Japanese banks, which faced less stringent capital rules.[5] The rise of the Japanese banking sector created an environment in which U.S. regulators were hard-pressed to maintain stability without harming bank profitability. It was precisely this environment that led U.S. regulators to press for an international standard on capital adequacy. Indeed, the Fed and the OCC were caught

table. Both agencies have since been dismantled and the FDIC is the sole insurance fund for all banking institutions. IndyMac, in fact, is an S&L regulated by the Office of Thrift Supervision, and its failure was managed by the FDIC.

[3] FDIC 1998.

[4] See Singer 2004, 2007.

[5] Singer 2004, 2007.

between the Scylla of competitiveness and the Charybdis of stability; creating an international standard was the safest path.

The U.K., coincidentally, was in a similar position in the 1980s. The U.K.'s financial instability began a bit earlier in the 1970s with the so-called secondary banking crisis. In 1979, largely as a result of the crisis, the Bank of England was finally granted the statutory authority to regulate and supervise the banking sector.[6] Then in 1984, London-based Johnston Matthey Bankers collapsed, triggering a strong regulatory response by the Bank of England. But the London banking sector, like the U.S., was aggressively fending off the incursion of Japanese banks (both in domestic markets and in international lending). By the late 1980s, regulators from the U.S. and the U.K. found themselves on the same side in advocating for a new international standard for capital adequacy. The result—the 1988 Basel Accord—would subsequently become the most prominent example of international financial regulation.

The fallout from today's subprime crisis is still in its infancy. With 13 bank failures thus far in 2008, we have far to go to reach the numbers of the 1980s (although FDIC disbursements will no doubt surpass the levels of the 1980s for commercial banks in real terms). Will today's financial crisis lead down a similar path to international regulation? I believe the answer is a qualified no. To be sure, international regulatory bodies have already begun to respond to the crisis. The Basel Committee and IOSCO, for example, are developing new "Guidelines for Computing Capital for Incremental Risk in the Trading Book" to address weaknesses in the capital cushion as it relates to banks' trading positions. The Basel Committee is also tweaking its recommendations for making prudent valuations of any positions subject to market risk, and attempting to address the issue of illiquidity (the problem that it is difficult to place a value on assets when they cannot easily be sold). IOSCO's new Task Force on Credit Rating Agencies will present a draft code of conduct at its upcoming annual meeting. The Joint Forum (which brings together the Basel Committee, IOSCO, and the IAIS) recently published a report, "Credit Risk Transfer: Developments from 2005-2007" to update a similar report in 2005. The report expresses concerns about the role of credit rating agencies, but its main purpose is to highlight the recommendations that were already made in the 2005 report (better stress-testing, more careful credit analysis of underlying assets to avoid over-reliance on credit agencies, etc.). These responses are useful and conscientious—I certainly do not mean to malign them—and indeed they demonstrate how existing international institutions can facilitate ongoing dialog and negotiation. But it seems unlikely that any new international standards will emerge from these discussions.

Ironically, the Basel II agreement revised the rule-based standards of its predecessor and instead emphasized principles and discretion. Under Basel II, large banks can use internal risk models—rather than standardized formulas and rules—to determine their own capital levels. Moreover, the agreement explicitly recognizes the legitimacy and accuracy of credit rating agencies in the process of determining the appropriate size of a bank's capital cushion.[7] The problems with Basel II have been addressed elsewhere.[8] As the current financial crisis unfolds, the notion that banks can successfully govern themselves using internal models—or rely insouciantly on credit rating agencies for risk evaluations—strains credulity. I will simply note here that the broadly-specified principles of Basel II can be adapted to address (if ostensibly) the shortcomings of the current regulatory environment. But the modification of existing principles of regulation within Basel II—if that indeed happens—should not be confused with the creation of a new international standard.

[6] The legislation was the Banking Act of 1979.
[7] On the influence of credit rating agencies, see Sinclair 2005.
[8] See, e.g., King and Sinclair 2003; Singer 2007; and Wood 2005.

The Politics of Accountability

The blame for the subprime crisis easily shifts from regulator to regulator, and from policymaker and policymaker. Members of Congress are quick to blame the bank regulators—specifically, the Fed (which oversees all member-banks of the Federal Reserve System), the Office of Thrift Supervision (OTS), and the OCC. Sen. Charles Schumer repeatedly claimed that OTS was "asleep at the switch" in the days surrounding IndyMac's failure. The bank regulators, however, can legitimately shift part of the blame to capital markets regulators and credit agencies. In recent testimony to Congress, OCC head John Dugan unabashed blamed credit agencies for giving banks a false sense of confidence in the security of "super-senior" tranches of collateralized debt obligations. He also noted that "nonbanks" were responsible for originating 90 percent of subprime mortgages in 2006.[9] More generally, bank regulators can blame the process of securitization—which traditionally falls under the jurisdiction of the Securities and Exchange Commission (SEC)—for disrupting the prudential management of banks' lending portfolios. Finally, all U.S. regulators can point to the structural causes of the crisis: the massive influx of foreign capital required to make up for persistent annual government budget shortfalls, and a prolonged period of abundant liquidity that led first to a "dot-com" bubble and then to a real-estate bubble.[10]

A regulator must feel threatened in order to advance an international agenda, including the creation of international standards. The Fed and the OCC are not inherently international agencies; indeed there is nothing in their charters that explicitly requires their engagement in any form of international negotiation. Political pressure from Congress must therefore be direct and unambiguous in order to spur regulators to press forward on the international front. Such pressure has not yet been manifest in the current crisis, and I believe the fragmentation of domestic accountability will help to shield bank regulators from the scorn they endured during the 1980s crisis.

In terms of agency accountability, the contrast between the 1980s and today is quite striking. When OCC chairman Todd Conover was summoned to testify before Congress after the failure of Continental Illinois in 1984, he had his tail between his legs. There was no question that the OCC's suite of regulations was lax, and its supervision negligent. Conover could not place blame on credit agencies, disintermediation, faltering investment firms, or permissive monetary policy. Members of Congress knew that they could score points with their constituents by raking the OCC over the coals. Today, the OCC's John Dugan can explain the status of the banking sector with references to the bailout of Bear Stearns, the culpability of nonbanks in the origination of subprime mortgages, the negligence of credit rating agencies, and financial innovation made possible by investment firms beyond the scope of the OCC's (and the Fed's) oversight. Members of Congress, of course, have electoral incentives to "do something," but they know that their constituents are just as confused as they are by phrases like "senior tranches of collateralized debt obligations." In short, as of this writing, it is not politically expedient for legislators to attribute accountability to any particular regulator. As a result, regulators have room to make cosmetic adjustments to capital requirements and can focus most of their efforts on reforming the rules for mortgage origination.

[9] Testimony of John Dugan before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 4, 2008.
[10] See Wade 2008 for a discussion of other fundamental causes of the crisis.

Regulatory Fragmentation and the U.S. Response

The U.S. has one of the most institutionally fragmented financial regulatory environments of any G10 country. Banks face an alphabet soup of regulators, including the Fed, the OCC, OTS, FDIC, the National Credit Union Administration, and separate State regulators, while the SEC, the Commodity Futures Trading Commission and other regulators monitor the capital markets. Most surprisingly, the U.S. does not have a federal insurance regulator; instead, 50 separate State regulators govern insurance firms within their jurisdictions. In the 1980s, when bank capital adequacy was unambiguously too low, the Fed, OCC, and FDIC combined forces in tightening capital adequacy requirements, and the Fed represented the group in the negotiations over the Basel Accord. The response to the current financial crisis will likely be much less coherent. For the reasons described above, there is no clear smoking gun; culpability is spread far and wide; and the welter of regulatory agencies does not bode well for a unified national stance in any international negotiation.[11]

While I doubt that any serious efforts at international harmonization will occur, I do think that the domestic regulatory environment in the U.S. may change. In the very short term, we should expect to see the creation of additional regulatory bodies, including a new commission to monitor Fannie Mae and Freddie Mac and an oversight board to monitor the $700 billion Congressional rescue package. Creating new regulatory entities is the quickest way for Congress to demonstrate that it is "doing something" to resolve the crisis. (Recall that Congress created the Public Company Accounting Oversight Board in the wake of the Enron/Worldcom fiascos.) Within several months, however, the U.S. might experience some agency consolidation. Treasury Secretary Henry Paulson has put forth a plan to dismantle OTS and grant more supervisory authority to the Fed. The Treasury's plan also calls for the creation of a national insurance regulator to replace the 50 separate regulators—although strong resistance from the State regulators may preclude any progress on this front.

Regulatory consolidation in the U.S. might be the most important catalyst for the creation of international regulatory standards in banking. Consider the immense challenges of creating a global standard—which most likely cannot occur without U.S. support—when the agencies *within* the U.S. are at odds with one another! Ironically, U.S. investment banks themselves may have cleared one obstacle to international cooperation: the remaining free-standing securities firms have opted to transform themselves into bank holding companies. This move reduces the SEC's influence and gives the Fed a more uniform role in supervising financial holding companies. Nevertheless, there is still considerable fragmentation in the regulation of a range of activities that clearly have an important bearing on the stability of the banking system. If today's financial crisis triggers the institutional consolidation of domestic financial regulation, then fruitful international negotiations will be more likely in the future.[12] But until such consolidation occurs, the welter of U.S. regulatory agencies will face considerable obstacles in addressing the complicated interactions between banking, disintermediation, and capital markets that are at the root of today's financial crisis.

---

[11] On the problem of national and/or international fragmentation of regulatory authority, see Mattli and Buthe 2003; Pauly 2008; Underhill 1997; and Wade 2008.

[12] Regulatory consolidation *within* the central bank (i.e., granting the Fed the authority to regulate securities firms) is a very different proposition from consolidation *outside* the central bank, as the U.K. has done with the creation of the FSA in the late 1990s. On the inflationary consequences of consolidating regulatory authority within the central bank throughout the developed world, see Copelovitch and Singer 2008.

References

Basel Committee. 2008. "Guidelines for Computing Capital for Incremental Risk in the Trading Book." Consultative document. Bank for International Settlements. July.

Copelovitch, Mark S., and David Andrew Singer. 2008. "Financial Regulation, Monetary Policy, and Inflation in the Industrialized World." *The Journal of Politics* 70, 3:663-680.

FDIC. 1998. "A Brief History of Deposit Insurance in the United States." International Conference on Deposit Insurance, Washington, DC.

Joint Forum. 2008. "Credit Risk Transfer: Developments from 2005-2007." Bank for International Settlements. July.

King, Michael R. and Timothy J. Sinclair. 2003. "Private Actors and Public Policy: A Requiem for the New Basel Capital Accord." *International Political Science Review* 24, 3:345-362.

Mattli, Walter, and Tim Buthe. 2003. "Setting International Standards: Technological Rationality or Primacy of Power?" *World Politics* 56, 1:1-42.

Pauly, Louis. 2008. "Financial Crisis Management in Europe and Beyond." *Contributions to Political Economy* 27:73-89.

Reinhart, Carmen M., and Kenneth S. Rogoff. 2008. "Is the 2007 U.S. Subprime Financial Crisis So Different? An International Historical Comparison." Working paper.

Sinclair, Timothy. 2005. *The New Masters of Capital*. Ithaca, NY: Cornell University Press.

Singer, David Andrew. 2004. "Capital Rules: The Domestic Politics of International Regulatory Harmonization." *International Organization* 58, 3:531-565.

Singer, David Andrew. 2007. *Regulating Capital: Setting Standards for the International Financial System.* Ithaca, NY: Cornell University Press.

Underhill, Geoffrey R.D. 1997. "Private Markets and Public Responsibility in a Global System: Conflict and Cooperation in Transnational Banking and Securities Regulation," in Geoffrey Underhill, ed., *The New World Order in International Finance*. (New York: St. Martin's), pp.17-49.

U.S. Senate. 2008. Testimony of OCC Chairman John Dugan before the Committee on Banking, Housing, and Urban Affairs. March 4.

Wade, Robert. 2008. "The First World Debt Crisis of 2007-2010 in Global Perspective." *Challenge* 51, 4:23-54.

Wood, Duncan. 2005. *Governing Global Banking*. Aldershot: Ashgate Publishing.

Author Biography

David Andrew Singer is an Assistant Professor of Political Science at MIT. Professor Singer studies international political economy, with a focus on international financial regulation, the influence of global capital flows on government policymaking, international institutions and governance, and the political economy of central banking. He is the author of *Regulating Capital: Setting Standards for the International Financial System* (Cornell University Press, 2007) as well as articles in *International Organization*, *Journal of Politics*, and *International Studies Quarterly*. His research has been supported by the National Science Foundation and Harvard University's Weatherhead Center for International Affairs and Minda de Gunzburg Center for European Studies. Professor Singer is a graduate of the University of Michigan and Harvard University, where he received his Ph.D. in 2004. Before joining the MIT faculty, he was Assistant Professor of Political Science at the University of Notre Dame (2004-2006), and also worked in corporate finance and technology venture development.