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## The Visible Hand Behind the Crisis

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By Editor Test     Tue, Jan 19, 2010

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*Viral Acharya and colleagues at NYU's Stern School of Business say the economy was pushed off a cliff by bankers skirting reserve requirements.*

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Anyone searching for a “visible hand” among the causes of the financial crisis should read the analyses written last year by professors at New York University’s Stern School of Business.

The overleveraging that made the collapse of the subprime housing crisis so deadly didn’t just happen, they say. It was pushed.

So argue Viral V. Acharya and Matthew Richardson in a paper called [“Causes of the Financial Crisis,”](#) which appeared in *Critical Review* last year. They also worked on a related paper, [“On the Financial Regulation of Insurance Companies,”](#) with NYU colleagues John Biggs and Stephen Ryan.

### Regulatory arbitrage

In their *Critical Review* article, Acharya and Richardson explain why the banks themselves were caught holding so many toxic assets:

Instead of acting as intermediaries between borrowers and investors by transferring the risk from mortgage lenders to the capital market, the banks became primary investors.

Since—unlike a typical pension fund, fixed-income mutual fund, or sovereign-wealth fund—banks are highly leveraged, this investment strategy was very risky. The goal, however, was logical: namely, to avoid minimum-capital regulations.

One of the two primary means for this “regulatory arbitrage” was the creation of off-balance-sheet entities (OBSEs), which held onto many of the asset-backed securities. These vehicles were generically called “conduits.” Structured investment vehicles (SIVs), which have received the most public attention, were one type of conduit.

With loans placed in conduits rather than on a bank’s balance sheet, the bank did not need to maintain capital against them. However, the conduits funded the asset-backed securities through asset-backed commercial paper (ABCP)—bonds sold in the short-term capital markets.

To be able to sell the ABCP, a bank would have to provide the buyers, i.e., the banks’ “counterparties,” with guarantees of the underlying credit—essentially bringing the risk back onto itself, even if it was not shown on its balance sheet. These guarantees had two important effects, however.

First, guaranteeing the risk to banks’ counterparties was essential to moving these assets off the banks’ balance sheets. Designing the guarantees as “liquidity enhancements” of less than one year

maturity (to be rolled over each year) allowed banks to exploit a loophole in Basel capital requirements. The design effectively eliminated the “capital charge” and thus banks achieved a tenfold increase in leverage for a given pool of loans.

They conclude that

The genesis of it all was the desire of employees at highly leveraged LFCIs (Large, Complex Financial Institutions) to take even higher risks, generating even higher short-term “profits.” They managed to do so by getting around the capital requirements imposed by regulators—who, in turn, were hoping to diminish the chance that deposit insurance, and the doctrine of “too big to fail,” might cause LFCIs to take just such risks.

Taking on more assets that were backed by insurance rather than reserves may have “looked like the desirable thing to do” for a department within a large bank, but it “would create excessive risk for the bank as a whole,” Acharya told RIJ. “From [the department’s] standpoint it all makes sense. The risk was hedged and most of the losses would be felt by the creditors if it failed.”

The banks were not unlike a balanced fund manager who over-weights equities during a boom. Until the market turns, investors see the profits that the “style drift” produces but not the risks. Such strategies—which some fund managers couldn’t resist during the dot-com boom—proved fatal to many of those funds and their investors in 2000.

### **Slippery slope**

In the case of ABCP conduits, banks largely provided insurance themselves, Acharya told RIJ. But in the case of AAA-rated tranches of sub-prime mortgages and corporate bonds and loans, they often bought insurance from elsewhere. This reduced capital requirements on these tranches practically to zero. That’s why the credit default swaps (CDS) prolifically written by AIG became so important.

The purchase of the credit default swaps by banks to insure against these tranches—in place of reserves—can be traced in part to the purchase of \$350 billion worth of such insurance purchased by European banks “as a temporary fix for the fact that capital requirements in the Basel I agreement had placed European banks at a competitive disadvantage to U.S. investment banks, which were given a head-start on Basel II treatment by the Securities Exchange Commission (SEC) in the United States,” Acharya told RIJ. That turned out to be a slippery slope.

“The moment you allow one player in the financial sector easier access to leverage, then everyone has to do it,” he said.

Moral hazard was ultimately responsible for the crisis, the NYU authors conclude. Federal deposit insurance for banks, state guaranty funds for insurers, belief in the principle of “too big to fail” and the limited liability of shareholders versus creditors all encouraged managers at large complex financial companies to take risks they otherwise would not have.

They recommend tighter regulation of banks and insurance companies and/or taxes that would force financial institutions to internalize the risks they are imposing on the financial system as a whole. In their August 2009 white paper, the NYU authors conclude:

“Insurance companies should not be able to offer “insurance”/protection against macro-economic events that yield systemic risk unless the insurance is fully capitalized. This would cover CDS on AAA-tranche CDOs, insurance against a nuclear attack, the systematic portion of insurance on municipal bonds, and so forth.

“A reworking of the accounting system for insurance companies to better aid the regulator and investors would also be desirable:

- The accounting for insurance policies should be made more/reasonably consistent with the accounting for substitutable risk-transferring financial instruments, such as derivatives. Fair value accounting, the usual accounting approach for these other financial instruments, is the best way to do this, but a not-too-distant alternative such as fulfillment value accounting may be adequate.
- The income smoothing mechanisms in statutory accounting principles (SAP) should be eliminated.
- Better financial report disclosures are needed for insurance policies that are written as put options on macroeconomic variables. These disclosures should clearly indicate concentrations of risk, how historical data is used to value the positions, and other important estimation assumptions.”