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Financial Services Outlook

# Bear Facts: The Flawed Case for Tighter Regulation of Securities Firms

## By Peter J. Wallison

*One of the best titles ever devised for a book about Washington was Lawrence F. O'Brien's* No Final Victories. *That's the way Washington really is; nothing is ever finally settled. The latest example of this phenomenon comes in the wake of the Bear Stearns bailout. Those who have always argued for more regulation now see a new day dawning, with an opportunity to impose greater controls on the securities industry and to ensure an enhanced role for the Fed. This is the only significant flaw in the Treasury plan for reorganization of the financial regulatory agencies. Regulating securities firms the way we regulate banks, and giving them routine access to the Fed's discount window, makes no practical or policy sense. Unlike banks, securities firms have no regular or inherent need for liquidity, and their failure—no matter how large they are—will not ordinarily cause a systemic event. Bear Stearns was bailed out because of the unprecedented fragility—indeed panic—in the world credit markets in mid-March. The fact that this has not happened in seventy years should tell us something. Accordingly, those who understand the failures and costs of regulation (to paraphrase the late William F. Buckley) should stand athwart the path to needless controls yelling "Stop!"*

There is no question that the Fed's rescue of Bear Stearns was a bailout. Yes, the shareholders received only a fraction of the value they probably expected for the firm—and it is plausible that this very low price was intended to discourage others from seeking the Fed's assistance in the future—but the transaction was a bailout because the creditors and counterparties of Bear Stearns were protected against loss, and that is the significant fact about this extraordinary event. By enabling Bear Stearns to be acquired by JPMorgan Chase, the Fed made sure that Bear Stearns's creditors and counterparties would be paid. The protection of these counterparties against loss is what creates the principal problem associated with bailouts—moral hazard.

The Fed, however, had no choice. The financial markets depend on confidence among counterparties in each other's solvency, and the collapse of Bear Stearns and losses suffered by its counterparties—even though those losses are still speculative today—would have spread new doubts through the financial system about other securities firms and banks. Once again, as with the collateralized-debt obligations that began this downward spiral, no one would have known where the losses were and which firms had been fatally weakened. The cascading losses—and the cascading *fear* of losses—would have been too much for the market to absorb at a time when it was already so fragile that the largest banks were afraid to lend to each other.

Instead of arguing about whether a bailout occurred, the ensuing debate should be about where we go from here. Headlines such as "Ten Days That Changed Capitalism"[1] are overwrought, and those that announced "Political Pendulum Swings toward Stricter Regulation"[2] are premature. It is important to keep these events in perspective. This is the first time in seventy years that the Fed has assisted a nonbank through the discount window. That should tell us that the turmoil in the financial markets that gives rise to genuine systemic risk is very rare. The current difficulties, then—unless there is a gross

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overreaction in Congress—should be considered neither a turning point in the capitalist system nor a basis for establishing a new, more comprehensive regulatory structure for the large investment banks. It should also be obvious that the Fed acted as it did—and with the approval of the Treasury—because of the fragility of the markets at the time. As Fed chairman Ben Bernanke himself said, "Under more robust conditions, we might have come to a different decision about Bear Stearns."[3] Broad statements that this changed the world or was made necessary because investment banking firms have become too big to fail are nonsense. There is no reason in principle that the failure of a securities firm—no matter how large—should be a systemic event. Securities firms and investment banking firms are different from banks, and people who believe that size alone is what determines whether a firm is too big to fail do not understand this difference.

> Does it make sense to place bureaucratic and regulatory restraints on a part of our financial industry that has been successful in dominating the global financial markets through extraordinary innovativeness and entrepreneurial skill?

Still, what happened with Bear Stearns is important. The markets learn not by what the government says but by what it does. The fact that the Fed and Treasury bailed out the creditors of Bear Stearns will leave a mark. For many years to come, market discipline of securities firms will be impaired, as some market participants will persist in believing that the largest securities firms have or will have the backing of the Fed when they need it and hence that they are less risky as borrowers than their true financial condition might warrant. The only way that this belief can be effectively countered is for a large securities firm to be allowed to fail. For better or for worse, these opportunities do not come along very often; Drexel Burnham and Kidder Peabody are two examples from the 1990s in which large securities firms were allowed to fail. A new and tighter regulatory structure for the largest securities firms will send exactly the wrong signal—that these firms are somehow under government protection. There is no doubt that if securities firms were to get regularized access to the Fed's discount window, some special degree of regulation by the Fed would be appropriate, but there is no good reason in policy or otherwise for that predicate to be established.

The argument that large securities firms should have regularized access to the Fed's discount window ultimately rests upon the erroneous notion that they are too big to fail. While this could conceivably be true for some banks, it is clearly not true for securities firms. As discussed below, there are key differences between commercial banks and securities firms that warrant a lender of last resort for the former but not the latter. As noted above, the Fed's actions in the Bear Stearns case were situation-related and not a judgment about the securities industry in general. Under these circumstances, the rationale for Fed regulation of investment banks (as opposed to commercial banks) falls apart.

Although there are some in Congress and elsewhere who propose regulation for every ill, regulation has not proven to be an effective way to promote financial market stability in the past. In the modern history of the United States, there have only been two cases in which substantial portions of an industry have collapsed, and both were depository institutions that were heavily regulated. In the late 1980s and early 1990s, 1,600 banks and roughly one third of all savings and loan associations (S&Ls) failed.[4] It is no coincidence that wholesale collapses occur in regulated industries: by increasing moral hazard—the sense that the regulators have things under control—regulation gives investors and creditors a false sense of security and increases the likelihood of excessive risk-taking, instability, and failure among regulated entities. Indeed, the current market turmoil that forced the Fed's hand on Bear Stearns began in the banking system, despite the pervasiveness of bank regulation. When we consider whether extensive new regulation should be extended to investment banks, especially if the objective is to create stability, we should consider these factors and others discussed below.

## The (Lack of) Success of Bank Regulation

Any objective look at bank regulation in the United States would have to conclude that it has been unsuccessful in a number of important respects. First, it has certainly not created stability. Banks have been regulated at the state level since they began as state-chartered institutions two hundred years ago and at the federal level since the establishment of the national bank system in 1863 under the Office of the Comptroller of the Currency. Despite this oversight, there were repeated bank panics and widespread failures throughout the nineteenth and twentieth centuries.[5] The Federal Reserve System was established in 1913 to mitigate or prevent these panics, but it was not successful in preventing massive numbers of bank failures before and during the Depression.[6] In 1933, a deposit insurance system was established that was intended to bring stability to the banking system, but, as noted above, the failure of large numbers of banks and S&Ls during the late 1980s and early 1990s resulted in a bailout that cost the taxpayers about $150 billion.

Moreover, regulation has bureaucratized the banks and sapped their entrepreneurial and innovative spirit. The banking system was once by far the largest and most important financial industry in the U.S. economy, but it failed to adapt sufficiently to changes in the economy and technology to retain its advantage over other competing forms of financial intermediation. Securities firms grew as large as they did in part because the banks were not as aggressive or innovative. Mutual funds, hedge funds, and private equity firms are also supplanting banks as the agents of change in finance. It should not be a surprise that none of the major securities firms are affiliated with banks—and that none of the securities firms acquired by banks after the Gramm-Leach-Bliley Act of 1999 permitted these affiliations—became or continued to be key players in the U.S. securities business.

This is not to say that banks should not be heavily regulated. There is no choice as long as the government operates a deposit insurance system through the Federal Deposit Insurance Corporation. Deposit insurance creates moral hazard by eliminating or severely reducing the incentive of depositors and creditors to follow with care the activities and risks of a financial institution to which they have advanced credit—a process known as market discipline. The power of market discipline to prevent excessive risk-taking and leverage should not be underestimated. During 2007, after months of punishing turmoil in the financial markets, the hedge fund industry—which many people had thought would be responsible for market instability because of its secretiveness and lack of regulation—was still remarkably stable. The industry consists of thousands of funds, managing almost $2 trillion in assets,[7] but during 2007, only forty-nine funds, representing $18.6 billion in assets, closed their doors. That was a smaller number of closures than in 2006, when the financial markets were functioning smoothly; in that year, eighty-three funds managing $35 billion closed down. Thus far in 2008, there have been a few hedge fund closures, representing $3.9 billion in assets.[8] The activities and strategies of hedge funds are completely unregulated, so their risks and leverage are controlled by nothing more than the wariness of and close observation by their investors—in other words, by market discipline.

In accepting deposit insurance in 1933, banks effectively became wards of the government. That has restrained their growth, flexibility, and responsiveness to change. Accordingly, the first question one should ask about extending bank-like regulation to the securities industry is whether it makes sense to place bureaucratic and regulatory restraints on a part of our financial industry that has been successful in dominating the global financial markets through their extraordinary innovativeness and entrepreneurial skill. This is especially questionable when the record of bank regulation has not produced the stability that the supporters of regulation expect.

## Why the Securities Industry Doesn't Need Bank-Like Regulation

Commercial banks make loans, which can be difficult to sell when they need cash to meet depositors' demands. In addition, when depositors generally want to hold cash instead of bank deposits, the need for a large number of banks to sell assets at the same time can drive down market prices and weaken the financial condition of the banks. This is exactly the same process that is causing turmoil in today's markets, although the reason is more complicated than a simple demand for cash by depositors. The Fed's discount window was established in order to address this problem. It allowed banks to pledge their best and most liquid assets to the Fed as collateral for loans, with the assurance that they could redeem the assets when the deposit withdrawals have ended and the loans are repaid.

In principle, then, discount window access should not be required for securities firms. Unlike commercial banking, in which the essence of the business is to acquire assets—loans—that are inherently difficult to liquidate, the securities industry presents a completely different pattern. Virtually all the assets of securities firms are securities, not commercial loans, and are thus inherently more liquid than the assets of banks. Securities can be sold or pledged for financing without difficulty when markets are functioning normally. Thus, if one were designing a system from scratch in, say, 2005, there would have been no reason to assume that any financial institutions other than commercial banks would need a facility like the Fed's discount window.

The reason that the usual liquidity of securities firms could not save Bear Stearns is that markets have not been functioning normally since the subprime meltdown began in June 2007. This has occurred for two principal reasons. First, the default rate on subprime loans made in 2006 and 2007 was well beyond any previously experienced, and many of these subprime loans were mixed in with prime loans in pools that were serving as collateral for mortgage-backed securities (MBS). Moreover, these MBS were themselves backing other collateralized debt obligations, so it became difficult for anyone to determine exactly where the losses were actually located. Under these conditions, the markets where these instruments were normally bought and sold virtually closed down, and Bear Stearns's collateral—the source of the firm's liquidity—lost much of its value. Second, the concurrent fall in housing sales, prices, and values—following the development of a huge bubble in housing prices—added further uncertainty to the task of determining which financial institutions were healthy and which were sick, and which pools of asset-backed securities were safe and which were not. As housing prices continued to fall, pools that had previously seemed strong began to look weaker, and it was impossible to make an estimate of risk until the full extent of the housing price decline became known. The loss of confidence thus far peaked in mid-March, when rumors spread through the market that Bear Stearns was going to fail. In normal times, Bear would have been able to borrow against its securities holdings, or sell securities to raise the cash necessary to instill confidence in its creditors and counterparties, but because of doubts about the quality of these assets, Bear was apparently unable to find counterparties who would accept these securities as collateral for financing.

There is no reason to believe that this unusual set of circumstances will occur again, just as it has not occurred in the last seventy years. As was true of the dot-com bubble, a new technology—in this case securitization—attracted a lot of enthusiasm and investment before all the pitfalls and risks were fully understood. In the future, participants in the securitization market will be more cautious; market participants, after all, learn from experience. It is important to note that bank regulators themselves neither understood the risks that were building up in the banking system nor warned the banks or the public about the dangers associated with dividing and subdividing payment streams from mortgages. Regulators, too, learn from experience, but what that means is that establishing a regulatory structure now to deal with today's problem will not protect us from tomorrow's. This is characteristic of regulators, who are fully capable of understanding risks and problems that occurred in the past but who, like the rest of us, cannot foresee the consequences of changes in the market or technology. "Omniscience," as Alan Greenspan said recently, "is not given to us. There is no way to predict how innovative markets will develop."[9]

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The collapse of Bear Stearns was an unfortunate event, but it is wrong to believe that the Fed would have stepped in if conditions in the financial markets at that moment were not so dire. The collapse and bankruptcy of Drexel Burnham and Kidder Peabody, as noted above, occurred without any substantial market impact. At the time of its collapse in 1990, Drexel was one of the most powerful firms on Wall Street, with 5,300 employees (compared with Bear's 14,000 employees seventeen years later), and it dominated the junk bond market with about 50 percent of all junk bond transactions. Drexel had asked the Fed for support, but was refused.[10] Extending bank-like regulation to the securities industry rests upon the false assumption that Bear Stearns would have been bailed out regardless of market conditions simply because it was a large financial player. To be sure, Bear Stearns was one of the major securities firms, but its failure under normal market conditions would not have caused systemic risk—no matter what its size.

The reason for this is another difference between commercial banks and investment banks. Commercial banks do not collateralize their borrowings. They borrow on the basis of their balance sheets. In addition, the business of banking requires that banks hold deposits from other banks, and banks are always in the process of clearing payments and deposits on which other banks may already have paid out funds. As an example, if a check drawn on bank A is deposited in bank B, it would not be unusual for bank B to allow its customer to use the funds before they have actually been collected from bank A. Multiplied millions of times a day, it is obvious that large sums are always in the process of collection between banks. If a large bank were to fail, its inability to meet its payment obligation would cascade down through the banking system, jeopardizing the ability of other banks down the line to make their own payments. That is why a large bank could be too big to fail.

Securities firms, also called investment banks, are entirely different. They do not borrow on the basis of their balance sheets. Instead, their borrowing is generally collateralized by the securities they hold. If they fail, their counterparties can sell the collateral, which is generally highly liquid, to make themselves whole. The problem that Bear Stearns and other investment banks have encountered in the recent market turmoil is that their collateral was no longer acceptable, or was not acceptable for the funding they needed. For this reason, it is incorrect to say that securities firms—simply because they are large or connected to many other firms—have become too big to fail. When markets are functioning normally, the failure of a securities firm does not have anything like the market effect of the failure of a bank, because the lenders and counterparties of securities firms are generally protected by collateralization of the obligations they hold. It was the fact that markets were not functioning normally that made the possible failure of Bear Stearns a systemic event. The collateral that would normally have protected the firm's counterparties could not be marketed, and the psychological effect of the failure would have seriously worsened the loss of market confidence that then prevailed.

> A compromise in which only the largest firms will be subjected to regulation will not work. If these firms alone are made eligible for Fed discount window access, they will have a significant competitive advantage over their smaller rivals.

At this point, it is worth saying a word about credit default swaps (CDS), because many people who favor regulation have cited CDS as a source of new risks in the financial economy. In a recent article in the *Financial Times*, for example, George Soros wrote: "There is an esoteric financial instrument called credit default swaps. The notional amount of CDS contracts outstanding is roughly $45,000 billion. . . . To put it into perspective, this is about equal to half the total US household wealth."[11] This is a highly misleading statement. It sounds like a scary number, as intended, but it bears no relationship to the actual amount of liability that a CDS—or all CDSs combined—might represent.

A CDS is a kind of financial guarantee or insurance, and in a CDS transaction, a protection buyer purchases protection against the default on an obligation (like a loan) by a borrower. The "notional amount" of a CDS is generally the principal amount of the loan on which the CDS is written, not the actual loss that might be incurred if there is a default. In effect, a CDS is a kind of insurance policy, with a purchaser of protection and a seller of protection. Like most insurance, it covers losses to property, but the property is seldom a total loss. For example, if a bank has made a loan to company A in the amount of $1 million (this is the notional amount), it might purchase protection against loss on the loan by entering a CDS with an insurance company. In this way, the bank converts its risk on company A into a risk on an insurance company, which is probably a net reduction in the bank's credit risk. As long as the loan is outstanding, the bank makes payments to the insurance company. If company A defaults, the insurance company pays the bank the $1 million and collects what it can from company A. The "default" could be a missed payment or something more serious, but the loss suffered by the insurance company is usually a fraction of the notional amount. Thus, the insurance company would carry its CDS obligation on its balance sheet at its fair value, which would be considerably less than the notional value of $1 million. As an example, in Bear Stearns's unaudited financial statements for the quarter ended August 31, 2007, the company reported derivative contracts including CDSs with a notional value of $2.2 trillion, but this notional value was carried on the firm's books at $40.3 billion, or about 2 percent of the notional amount. Similarly, the notional amount of Merrill Lynch's payout obligations under derivative contracts was $4 trillion, which the firm was carrying (according to its unaudited financial statements as of September 27, 2007) at $111 billion, or approximately 2.5 percent.

When any firm is selling credit protection in the form of a CDS, its counterparty looks to the seller's financial strength. This is true in any insurance or guaranty transaction. Counterparty risk is always present and often hedged. But if the protection seller defaults, as might have occurred with Bear Stearns, the losses suffered by its CDS counterparties are not direct losses on the loans or other obligations insured by the CDS but the loss of the *insurance* they had purchased. In the worst case, the buyers of protection from Bear Stearns would have had to put the full principal amount of the original loans back on their balance sheets. Alternatively, they could have entered new CDSs with more stable counterparties. Bear Stearns's failure would have exposed many counterparties to serious losses, but only if the underlying loans or securities—which Bear Stearns was insuring—themselves went into default. Of course, those who had sold protection *against* a

Bear Stearns default would have been required to pay up, but in the normal case this risk would have been spread widely throughout the markets. Again, in the fragile and panicked markets of mid-March this might have been a problem; in normal markets—what Bernanke called more "robust" markets—that is not likely.

From this discussion, it should be obvious that CDSs are not the scary instruments that the proponents of regulation, such as George Soros, would have people believe. The existence of CDSs is not a reason for adopting stronger regulation, and the growth of CDSs has not changed the financial world or made it riskier. On the contrary, as shown by the hypothetical CDS transaction between the bank and the insurance company outlined above, CDSs can represent an efficient way for companies to hedge their risks or (in the case of the insurance company) to take on risks that give them valuable diversification and a cash flow.

## Would Regulation Be a Cure?

Despite its repeated failures, the continued faith in financial regulation as a way to prevent future instability, or to protect against the recurrence of the current market problems, is somewhat touching. We have already seen that regulation did not prevent instability in the heavily regulated banking industry; did not prevent the banks from leading the financial parade that eventually gave rise to the subprime meltdown and the current worldwide financial turmoil; and oversaw the decline of the banking industry as an innovative, entrepreneurial, and aggressive competitor in the financial markets. These outcomes demonstrate that regulators do not have foresight or skills superior to those of market participants themselves.

In addition, although we would like regulators to act countercyclically, they are unable to do so because they operate in a political system. Many in Congress are now blaming the regulators for not acting to prevent the subprime meltdown and are devising schemes to enhance regulatory authority in the future, but the reaction in Congress would have been entirely different if—say, in 2006—the Fed or some other bank regulator had imposed restrictions on bank financing of adjustable-rate mortgages or mortgages with small or no down payments. In that case, the outcry in Congress would have been enormous, with lawmakers claiming that this action was interfering with the hopes of ordinary Americans to achieve the American dream of homeownership. Hearings would have been scheduled, as they are now scheduled to second-guess the Fed and the Treasury about the Bear Stearns bailout, and the regulators would have been called on the carpet in front of television cameras to explain why they were interfering with a market that was providing what all Americans want. The regulators know this. Their very human reaction is to hope for the best and leave the problems for someone else's watch.

> The foundational idea in the Treasury plan is that banks, securities firms, and insurance companies represent a single financial services industry—not three separate industries—and ought to be regulated that way.

Finally, one has to ask which firms will be regulated by any more comprehensive system of regulation applicable to the securities industry. Those who are promoting regulation seem to be thinking that it will be applicable to the largest firms in the securities industry—Merrill Lynch, Morgan Stanley, Goldman Sachs, Lehman Brothers, and perhaps a few others. But there is a difficult line-drawing problem here. The securities industry consists of over 5,000 broker-dealers, large and small, engaged in all aspects of the securities business. Are all of these to be more heavily regulated because a few of the largest ones might one day ask for access to the Fed's discount window? On the other hand, if only the largest are to be heavily regulated, on what basis will they be selected? One can be sure that because of its costs—tangible and intangible—additional regulation will be resisted by all firms that are threatened with heavier regulation, even those that are among the largest. The rationale for imposing heavier regulation on small securities firms is weak—unlike banks, the securities business does not by its nature require the holding of illiquid assets—and the opposition of the industry as a whole will be strong.

But a compromise in which only the largest firms will be subjected to regulation will not work either. If these firms alone are made eligible for Fed discount window access, they will have a significant competitive advantage over their smaller rivals. Creditors and counterparties will prefer to deal with firms that are more heavily regulated and have the potential to borrow from the Fed, rather than those that do not. And that additional regulation and access will not only upset the competitive balance within the industry, but it will also go some distance toward creating moral hazard and reducing market discipline. In other words, greater regulation and discount window access will create a competitive imbalance within the securities industry, while diminished market discipline for the largest players will ensure that the securities industry will see greater instability in the future.

## The Treasury Plan

In announcing the Treasury plan, Secretary Henry M. Paulson made some sensible statements that seem to have been lost in the media frenzy that followed:

> Some may view these recommendations as a response to the circumstances of the day; yet, that is not how they are intended. This Blueprint addresses complex, long-term issues that should not be decided in the midst of stressful situations. . . . These long-term ideas require thoughtful discussion and will not be resolved this month or even this year. . . . I am not suggesting that more regulation is the answer, or even that more effective regulation can prevent the periods of financial market stress that seem to occur every ten years. . . . This is a complex subject deserving serious attention. Those who want to quickly label the Blueprint as advocating "more" or "less" regulations are over-simplifying this critical and inevitable debate.[12]

The Treasury plan is divided into three parts—short-term, intermediate-term, and long-term recommendations. The intermediate-term ideas are all sensible. They involve the merger of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission, the establishment of an optional federal charter for insurance companies (which are now regulated only at the state level), and the phaseout of the thrift charter. These are not particularly adventurous or bold ideas—as hard as they will be to achieve in today's Washington—but they are sound steps in the right direction.

The heart of the Treasury plan is the long-term restructuring. As Secretary Paulson indicated, these proposals are intended to be debated over time and are not designed specifically for the problems of today. They are both innovative and bold. With one major exception and one minor one, they deserve serious consideration, and because of their underlying logic, they will probably set the direction that reform will ultimately take. Although everyone who has a stake in the current structure, who lacks imagination, or who fears change is now taking potshots at this portion of the plan, the Treasury staff members who worked so hard on it should not be discouraged. During the Reagan administration, the Treasury proposed a plan for bank deregulation that would have eliminated the affiliation restrictions of the Glass-Steagall Act and many other restrictions on affiliations between banks and other financial services providers. That plan was also attacked from all sides and never received more than a courteous nod from a Republican Senate. But the idea kept coming back because it was the only idea that made sense, and it was finally adopted eighteen years later as the Gramm-Leach-Bliley Act of 1999.

The foundational idea in the Treasury plan is that banks, securities firms, and insurance companies represent a single financial services industry—not three separate industries—and ought to be regulated that way. In reality, these firms are all competing with one another, and as long as this is true it makes no sense to regulate them separately. The Treasury plan proposes to set up two regulatory agencies—one to regulate the safety and soundness of the companies that make up these three industries and the other to regulate business conduct, which probably means consumer protection. A variation of this structure was adopted in the United Kingdom several years ago and has since functioned well. Importantly, the Treasury plan would take holding company regulation away from the Fed and place it where it belongs—at the level of the bank or prudential regulator. However, two agencies seem unnecessary. The reasons given for two agencies in the plan discussion were weak, and everything we know about bureaucracies tells us that two agencies with jurisdiction over the same entities will fight endlessly over jurisdiction; some business conduct rules will affect safety and soundness and vice versa. The Financial Services Authority in the U.K. combines both functions in one agency, and that seems to make more sense.

A major objection is the proposed role for the Fed. Despite Secretary Paulson's statement, establishing the Fed as an anti–systemic risk SWAT team looks suspiciously like something that was added to compensate the Fed for depriving it of holding company supervision. If this was the reason, it was one of the few concessions that the long-term elements of the plan made to interagency politics, and it is a bad idea. As discussed above, regulators do not have the ability to spot and prick incipient bubbles, and, in any event, Congress will step in to stop any actions that interfere with the party that is going on as a bubble is growing. There were plenty of indications before the subprime meltdown that the housing economy was overheating, but no regulator felt that it had sufficient clout to stand up to Congress and call a halt. As for sniffing out innovations that might one day lead to systemic risk, that is simply a fantasy. Innovations like asset-backed securities, CDSs, and dividing and subdividing MBS into increasingly complex assets—all market developments that have been charged with responsibility for the subprime crisis of today—have good elements as well as bad. Among the good are the spreading of risk beyond depository institutions and market efficiencies that substantially lower consumer costs for credit. It is doubtful that any human being, let alone a bureaucracy like the Fed, could have predicted that these instruments, when combined with an unprecedented subprime default rate and fair value accounting, would cause the market turmoil we are experiencing today. Worse still, if the Fed actually tries to shut down market innovations it fears, we will see the destruction of the kinds of innovation that have driven financial market progress over the last quarter century.

It does not appear that the Treasury plan envisions regularized access to the Fed's discount window by securities firms, although one of the short-term elements of the Treasury plan contemplates cooperation between the Fed and the SEC in providing the Fed with the necessary information about the securities firms that might be potential discount window borrowers during the current period of market turmoil. That is the good news. The bad news is that many in Congress believe that regulation creates stability, that CDSs are creating new and unmanageable risks in the financial markets, that the failure of a large securities firm can cause systemic risk, and that regulators have foresight superior to market participants. As long as these ideas are current, there will always be a threat of increased government control of the financial markets.

*AEI research assistant Karen Dubas worked with Mr. Wallison to produce this* Financial Services Outlook.

## Notes

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