THE WALL STREET JOURNAL. ONLINE

April 2, 2008

OPINION

Barbara Kelley

The KISS Rule for Markets

By LAWRENCE B. LINDSEY
April 2, 2008; Page A15

Just about every politician is demanding an overhaul of financial regulation. Meanwhile, Treasury Secretary Hank Paulson has just issued the Treasury department's report on the subject. In thinking through the various proposals, we should always keep in mind that existing political and regulatory regimes contributed to our current problems – even as they, in turn, were attempts to address the perceived problems of the times in which they were enacted.

This is not an assignment of blame. Rather, it is a reminder that, in these days of soaring rhetoric about a "culture of corporate greed," the political class does not have moral standing to be casting the first stone.

If we are to get regulation right, or at least more right than in the past, we should understand some of the fundamental facts about human beings that are manifested in markets, political behavior and the institutional behavior of large regulatory bureaucracies. Here are three rules:

- *Both markets and the political process are inherently pro-cyclical.* When things are going up, both markets and politicians will push things to excess; then they will repeat the process on the down side.

In the case of markets, the dynamic is driven by fear and greed. During the Bubble of the 1990s, technical analysts found that "momentum plays" were profitable – i.e., buy what has been going up because it will go up some more. In this decade, people bought more housing than they could afford and lenders were willing to finance them, because houses "never go down" and because the appreciation of house prices far exceeded the carrying costs.

Politicians are also always cheerleaders on the way up. The late Federal Reserve Governor Ned Gramlich observed the bipartisan cheerleading for the housing bubble in a speech prepared for delivery at last year's Jackson Hole Conference, noting that both the Clinton and Bush Administrations were equally guilty. Gramlich, a Democrat, chaired the same committee on the Federal Reserve Board that oversees housing and consumer regulation during the Bush administration that I chaired as a Republican during the Clinton years.

Both administrations supported ever-easier standards for mortgage lending. Contrary to the claims last year of Sen. Barack Obama, it was never the financial services industry (in my experience) that lobbied for easier lending terms. Rather it was politicians who sought easier lending regulations so more constituents could borrow. Community activists (Mr. Obama's occupation before becoming an elected official) also put on the pressure.

In fact, Rep. Barney Frank (D., Mass.) is the only politician I know who has argued that we needed tighter rules that intentionally produce fewer homeowners and more renters. Politicians usually believe that homeownership rates should – must – go ever higher. The rarity of Mr. Frank's contrarian thinking is a reminder that when markets are committing excesses, we certainly should not expect Washington to act as a check on them.

- *Politicians, and the regulators they hire, and delegate to, will layer on new and sometimes mutually exclusive objectives for the financial services industry.* This second rule follows from the first. In the early 1990s, Congress had no sooner finished legislating highly restrictive lending standards (after cleaning up the Savings and Loan disaster) than it began demanding an easing of those standards so that more people could get mortgages. Most prominent of these was easier downpayment requirements for would-be home buyers with low and moderate incomes.

The current presidential candidates are playing this contradictory game today, even before we've fixed the mess we're in. John McCain called for a reconsideration of mark-to-market accounting, while also being a big proponent of more transparency. Hillary Clinton wants to encourage mortgage lending to break the housing log jam, while placing a freeze on mortgage interest rates and reducing the collateral value of housing by restricting the foreclosure option.

Mr. Obama wants to put a "floor" under housing prices by forced write-downs of mortgages so that people can stay in their homes. He doesn't mention how the resulting lost capital in the financial industry will be recouped so that the financial meltdown doesn't get worse. Because his plan also excludes vacant housing units, of which we have roughly three million too many, it cannot put a floor under the price of occupied homes. Nor can home values be preserved without a vibrant and profitable lending industry.

The rather unremarkable observation that the things politicians want are sometimes contradictory, not to mention hypocritical or infeasible, leads to the third rule.

- *Regulatory institutions created to carry out conflicting missions become entrenched, making any changes a political hot potato*. For example, regarding the regulation of state-chartered banks, the Paulson report said that jurisdiction could be shifted to the Fed, which has responsible for payments systems and overall economic health, or to the FDIC, which has responsibility for protecting the depositors in case the bank fails. But it didn't take sides. Another example in the report: It suggests the Securities and Exchange Commission and the Commodity Futures Trading Commission be merged, but given their radically different institutional cultures and political and financial constituencies, it doesn't say explicitly which one prevails.

Regulations should at the least be as transparent and simple as possible. This makes it less subject to manipulation by markets, politicians or regulators, and is a far more important principle than the institutional design.

The root of the current problem is excess leverage and the target of the new regulatory push is the investment banks. Bear Stearns had a balance sheet 50 or more times the size of its capital. Goldman Sachs has $1.1 trillion in assets backed by $40 billion in equity, a figure that grew under both Bob Rubin and Hank Paulson. What is really needed is a limit on the leverage ratio of these banks. Ironically, we have a limit on commercial banks – but it has fallen out of favor and indeed was suggested for elimination as we negotiated Basel II rules a few years ago.

The one regulator who understood the problem is the former head of the FDIC, Don Powell. He used to be a Texas banker, and had seen what happens during financial meltdowns. In 2005 he fought the other regulators who preferred complex "risk-based capital" rules. Risk-based standards were so much more sophisticated than a simple leverage ratio that only a favored few in regulatory institutions or in compliance departments understood their implications. Regulators should remember KISS – Keep It Simple, Stupid.

A second key to regulation at this stage of the cycle is to "let a hundred flowers bloom." The current system of mortgage securitization isn't working and we need an alternative. But there is no single obvious solution that is credible enough for borrowers, lenders and the political process to all accept.

Rather than mow down options as they sprout up with new, sweeping regulations, we should see what works first. Done right, regulatory behavior like setting flexible "best practice" standards can shape developments without foreclosing workable options. For example, government could supplement the rating agencies by offering certain best-practice standards for mortgages resold in securities – and even certify that the mortgages in those securities meet those standards – without requiring that *all* mortgages (or even all securitized mortgages) meet them.

Whatever option emerges, we inevitably will have another market cycle, with attendant excesses, and politicians will support the upside until the cycle turns and they switch to hunting for culprits to blame. But we can postpone this inevitable cycle of human behavior by avoiding regulatory schemes involving hard-wired solutions that can be gamed by those who are the most clever, or the most short-sighted.

Mr. Lindsey, president and CEO of the Lindsey Group, was President Bush's chief economic adviser from 2001 to 2002. He is the author of "What a President Should Know . . . But Most Learn too Late" (Rowman & Littlefield, 2008).