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RESEARCH SUMMARY

Regulation, CDO Exposures, and Debt Guarantees through the Financial Crisis

Collateralized debt obligations with asset-backed securities as collateral (ABS CDOs) performed extremely poorly during the 2007–2009 financial crisis. Their role is often downplayed in postcrisis policy debates about what went wrong. In “Regulation, CDO Exposures, and Debt Guarantees through the Financial Crisis,” Steph Miller shows how regulatory factors could have spurred growth in the market for these financial instruments and contributed to the distress among large commercial bank holding companies (BHCs) during the crisis.

MARKET FAILURE, REGULATORY FAILURE?

Conventional wisdom tends to attribute the CDO market performance during the 2007–2009 crisis to market failure. But as Miller points out, the poor performance also reflects an unintended consequence of regulation.

- Finding #1: A 2001 regulatory change called the Recourse Rule made holding the highest-rated ABS CDO tranches more favorable by lowering required capital on those tranches. This could have encouraged banks to take on even more risk—and to do so under conditions whereby they were less prepared to absorb risk.
- Finding #2: US banks can and do comment on rulemaking during the notice-and-comment period, and large BHCs with subsidiaries that submitted comment letters during the Recourse Rule rulemaking process, and especially the subset that originated CDO deals, had higher estimated debt guarantees during the crisis but not before.
- Finding #3: BHCs that had greater holdings of CDO tranches experienced higher estimated debt guarantees, whereas holdings of other trading assets had little or no effect on the size of BHC’s debt guarantees.

These results suggest that the lower minimum capital requirements for the highest-rated CDO tranches could have driven the demand for securities that contributed to large BHC distress.

KEY TAKEAWAY

Like regulation in the United States generally, bank capital regulation is becoming increasingly complex. A primary goal of this regulation is to reduce the risk of bankruptcy of financial institutions, particularly banks.

Regulation has enabled banks to keep their capital historically low. As a result, bank insolvency risk—especially for the largest banks—could still be a concern, with the taxpayers likely on the hook to bail out those banks in the event of another crisis.