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RESEARCH SUMMARY

The Recourse Rule, Regulatory Arbitrage, and the Financial Crisis

In retrospect, it's easy to point to supply-side factors, such as greed and weaker lending standards, as causes of the recent financial crisis. But demand-side factors, such as regulations, could have played a role in causing the crisis as well—only they can be harder to measure. For instance, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency finalized the so-called Recourse Rule on November 29, 2001. The rule lowered capital requirements on private-label securitization tranches (bond-like securities issued in the process of securitizing assets) that had higher credit ratings. The rule change could have encouraged the largest securitizing banks that created these tranches to hold onto more of them—and some of these were the tranches that experienced distress during the 2008 financial crisis.

In "The Recourse Rule, Regulatory Arbitrage, and the Financial Crisis," Stephen Matteo Miller, a senior research fellow at the Mercatus Center at George Mason University, investigates the unintended consequences of the change in regulatory capital requirements and how the change might shed light on the demand-side factors of the financial crisis. He finds that larger securitizing banks increased their holdings of the highly rated tranches after the Recourse Rule was finalized until the onset of the crisis. Moreover, banks with greater holdings of the highly rated tranches were more exposed to losses as the crisis unfolded.

KEY POINTS

- The data suggest that, on average, after the Recourse Rule went into effect the holdings of highly rated tranches by the largest securitizing banks increased relative to those of most other banks. In contrast, banks with less than $10 billion in assets show nearly constant holdings.
- The average holdings of highly rated tranches relative to Tier 1 capital for the largest securitizing banks rose from 0.24 in Q4 2001 to a peak of 1.04 in Q3 2007. The average ratio for banks in the $10 billion–$50 billion range never exceeded 0.56 during the period studied, while the average ratio for the smallest banks never exceeded 0.14.
- It is only in the period from Q1 2008 (when the Federal Reserve introduced the Term Securities Lending Facility to purchase the risky assets) through Q1 2009 that holdings of the highly rated tranches become associated with large declines in distance-to-default (which reflects increased risk of default).
- Taken together, these findings suggest that capital adequacy could have been a problem in the run-up to the crisis. Even though banks might have satisfied regulatory capital requirements, lowering capital requirements for some of the very assets that experienced distress during the crisis resulted in banks experiencing large declines in the market value of their capital.
- While these findings do not establish that the Recourse Rule caused the financial crisis, they are consistent with the view that the rule encouraged securitizing banks, especially the largest ones, to hold

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the assets that turned out to be at higher risk of distress. In other words, though the Recourse Rule may have been intended to lower risk-taking, it may have encouraged greater risk-taking on the part of these banks.