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How Regulators Herded Banks Into Trouble

*Blame the Basel capital standards for over-investment in mortgage-backed securities and now government debt.*

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For many in the U.S., the worrisome events occurring in Europe recall the 2008 financial crisis. If Greece or some other country should fail to meet its debt obligations, the result could be much like the 2007 mortgage meltdown in the United States. Many banks and other financial institutions in Europe, and some in the U.S., may be weakened by the loss in value of the sovereign debt they hold. Why is all this happening again?

The important factor in both the American and European cases is what is known to scholars as a common shock—a sharp decline in the financial condition and regulatory capital of a large number of financial institutions because a widely held asset has suddenly lost its value.

In the U.S., this shock came when the 10-year housing bubble deflated and U.S. financial institutions were weakened by a sudden loss in value of the mortgage-backed securities (MBS) they were holding, especially those based on subprime mortgages. Mark-to-market accounting did the rest, requiring banks to write down the value of their MBS assets until they appeared unstable or insolvent.

In Europe, the problem is similar and so is its source. Europe's banks, like those in the U.S. and other developed countries, function under a global regulatory regime known as the Basel bank capital standards. Basel is the Swiss city where the world's bank supervisors regularly meet to consider and establish these rules. Among other things, the rules define how capital should be calculated and how much capital internationally active banks are required to hold.

First decreed in 1988 and refined several times since then, the Basel rules require commercial banks to hold a specified amount of capital against certain kinds of assets. Under a voluntary agreement with the Securities and Exchange Commission, the largest U.S investment banks were also subject to the form of Basel capital rules that existed in 2008. Under these rules, banks and investment banks were required to hold 8% capital against corporate loans, 4% against mortgages and 1.6% against mortgage-backed securities. Capital is primarily equity, like common shares.

Although these rules are intended to match capital requirements with the risk associated with each of these asset types, the match is very rough. Thus, financial institutions subject to the rules had substantially lower capital requirements for holding mortgage-backed securities than for holding corporate debt, even though we now know that the risks of MBS were greater, in some cases, than loans to companies. In other words, the U.S. financial crisis was made substantially worse because banks and other financial institutions were encouraged by the Basel rules to hold the very assets—mortgage-backed securities—that collapsed in value when the U.S. housing bubble deflated in 2007.

Today's European crisis illustrates the problem even more dramatically. Under the Basel rules, sovereign debt—even the debt of countries with weak economies such as Greece and Italy—is accorded a zero risk-weight. Holding sovereign debt provides banks with interest-earning investments that do not require them to raise any additional capital.

Accordingly, when banks in Europe and elsewhere were pressured by supervisors to raise their capital positions, many chose to sell other assets and increase their commitments to sovereign debt, especially the debt of weak governments offering high yields. If one of those countries should now default, a common shock like what happened in the U.S. in 2008 could well follow. But this time the European banks will be the ones most affected.

In the U.S. and Europe, governments and bank supervisors are reluctant to acknowledge that their political decisions—such as mandating a zero risk-weight for all sovereign debt, or favoring mortgages and mortgage-backed securities over corporate debt—have created the conditions for common shocks.

But that is not all that can be laid at the door of regulators. Examiners and supervisors operating "by the book" tend to disregard the judgments of bank managements in favor of regulator-approved methods of assessing credits and carrying reserves. As banks begin to conform to regulator preferences, natural diversification declines and all banks start to look pretty much alike. Then, like genetically altered plants, they are vulnerable to a pathogen—like MBS backed by subprime mortgages—that sweeps through the population.

This does not mean that all regulation is counterproductive. Yet the way it is currently pursued under the Basel rules will—through encouraging future common shocks—make the financial system more, rather than less, vulnerable to systemic breakdowns. To create a stable financial system, regulators should encourage asset diversification and do away with the Basel risk-weighted capital system.

Congress then should repeal Dodd-Frank, which authorizes the Federal Reserve to supervise all "systemically significant" nonbank financial firms, thus spreading dangerous conformity to insurance and finance companies, hedge funds and others. Stability can come only when we stop rewarding herding behavior, and penalize it instead.

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