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CAPITOL REPORT

Roots of credit crisis laid at Fed's door

Regulatory minimalism allowed risky practices to flourish, expert says

By Greg Robb, MarketWatch
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WASHINGTON (MarketWatch) -- In the wake of the financial market turmoil that arose over the summer and even now threatens to push the U.S. into recession, there has been a remarkable lack of finger-pointing so far over the cause of the crisis.

But one observer, Tom Schlesinger, the founder and executive director of the Financial Markets Center, a think tank that has followed the Federal Reserve closely for the past decade, believes the blame for the crisis falls squarely on the Fed and accuses the central bank of "regulatory foot-dragging" that has harmed the public.

Schlesinger maintains the Fed's prevailing regulatory philosophy has shifted from that of 20 or 25 years ago, which in essence was "here is the line between right and wrong, don't cross it," to a current underlying policy that "anything and everything that might be called financial innovation ought to be embraced."

"This is a very faulty premise that deserves debate and reflection and ultimately, in my opinion, a changed perspective," Schlesinger said in an interview with MarketWatch.

He points specifically to the opposition to government regulation that flourished at the U.S. central bank under former Fed chief Alan Greenspan and has continued unabated under his successor Ben Bernanke.

At the time Bernanke was preparing to succeed Greenspan, Schlesinger predicted his

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biggest challenge would be the aftermath of Greenspan's laissez-faire approach to regulation.

Willing to go only so far

The current credit crisis began early in 2007 with rising delinquencies in the subprime mortgage sector. Like a slow fuse, these difficulties spread throughout the global financial system as investors realized that these bad mortgages had been securitized, pooled together and sold to financial institutions around the world.

By early August, parts of the financial system were close to frozen and central banks were forced to inject billions of dollars to add liquidity to maintain the workings of the credit markets.

Over the last two months, some markets have recovered, but problem areas remain, particularly in the London market for structured investment vehicles, or SIVs. There is concern in financial markets about bank exposure to these investment pools and concern that possible forced sales of their assets might shock already jittery credit markets.

Separately, Bank of America, JPMorgan and Citigroup are leading a plan to raise $80 to $100 billion to help buy some of the assets held by SIVs facing collapse.

But these same international bankers spent last weekend in the corridors of the International Monetary Fund's annual meeting urging government officials not to rush to adopt new rules to get the financial market turmoil under control.

Schlesinger calls this reaction by bankers "misguided, predictable and familiar."

"It is sort of stunning that as the biggest banks prepare to conduct a bailout of unprecedented scope, they are at the same time warning for excessive caution on the regulatory side, which is exactly the type of approach that might have spared some of them the consequence of their own worst excesses," he said.

Early warnings went unheeded

In his recent autobiography, Greenspan said when he accepted the top Fed job, he worried

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and said he planned to allow others at the Fed to take the lead.

Upon joining the Fed, Greenspan said he had a "pleasant surprise" when he found the Fed staff was not so keen on regulation either. Together, they interpreted congressional legislation with a view to "letting markets work," he wrote.

Schlesinger says this practice was actually "regulatory foot-dragging" where the Fed had a clear obligation under law to police markets but went about it "with such reluctance that in some cases the supervision is difficult to detect."

A perfect illustration of how this "regulatory minimalism" impacted the current market crisis is the Fed's lack of regulation of SIVs that have been under pressure.

In January 2003, after a review of the collapse of Enron Corp., a Senate investigation found that some major U.S. financial institutions had "deliberately misused structured finance techniques" to help Enron engage in deceptive accounting or tax strategies in return for millions of dollars in fees. Read Senate report.

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The staff report recommended that the Fed and the Securities and Exchange Commission review how banks use complex structured financial products and issue guidance on acceptable and unacceptable practices by the end of 2003.

But the Fed and the SEC opted against coming out with a list of new guidelines, stating that they favored a principles-based approach rather than a more prescriptive approach to regulation. Schlesinger contends this resulted in the agencies issuing final guidance in 2006 "that in essence said do whatever you want -- anything goes."

"This is a perfect example of the unwillingness of the Fed to take a strict approach to policing structured finance products has come back to haunt the entire system," he said.

Could frenzy have been prevented?

In addition, the Fed also could have dampened the Wild West market conditions for subprime mortgages that resulted in so many poor loans due to fraud, says Schlesinger.

In an interview on the CBS News' program "60 Minutes," Greenspan said the Fed couldn't stop subprime mortgage originators.

Schlesinger disagrees. Although the abuses came from independent originators and not banks, Schlesinger said the Fed had "all or most" of the authority it needed to police the market under two laws passed by Congress.

"The Fed's unwillingness to flex the muscle that those statues granted is a real black mark

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on the central bank," he said.

Schlesinger detects no change in the Fed's regulatory stance in the 20 months since Bernanke took the reins at the Fed, saying if there is any re-examination of policy underway the Fed isn't talking about it in public.

Bernanke will have a chance to put his own stamp on regulation in coming months as congressional democrats take an interest in consumer protection in the wake of the debt crisit. See full story. The Fed has already promised to craft rules to address deceptive mortgage lending practices.

Schlesinger said he has some hope the regulatory pendulum will eventually move in the other direction, but cautions it won't be an easy shift.

"It will require some real assertiveness in Congress that has been by-and-large pretty passive on these issues. I think it will also take some real dissent, debate and new thinking in academia and the economics profession as well," he said.

Greg Robb is a senior reporter for MarketWatch in Washington.

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