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The Financial Crisis and the Future of Law and Economics

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Book Review

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A Failure of Capitalism: The Crisis of ’08 and the Descent into Depression

by Richard A. Posner

Harvard University Press, 2009

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I. Introduction

A Failure of Capitalism is an outstanding but, in many respects, quite unusual contribution. Written by one of the most innovative and intellectually inquisitive legal scholars in the United States, indeed the world, it has attracted much public attention. It is provocative and highly stimulating. Its content is sophisticated and its style highly readable. But Judge Posner gained his fame as the dean of the law and economics movement, about which he literally wrote the book.¹ There is plenty about economics in A Failure of Capitalism, but virtually nothing about law. Reading it, one might imagine that banking is a largely unregulated industry, such that law could not have played any role in causing the crisis. But banking remains highly regulated, and, I shall argue, these regulations can very plausibly be held responsible for the crisis. Thus, the proposals for

¹ Richard Posner, Economic Analysis of Law 593 (7th ed. 2007)
preventing future crises largely involve changing the laws that, Judge Posner notwithstanding, closely govern commercial banking. It is unfortunate but true that lawyers cannot intelligently contribute to these proposals if their knowledge of the crisis comes solely from Judge Posner’s book.

Systemic risk reduction is the target of these reform proposals. Reducing systemic risk entails understanding its sources. Posner recognizes this, but since he does not acknowledge the regulatory roots of the crisis, he turns to macroeconomics to explain systemic risk. In his “Failure of Capitalism” blog, he has followed up by encouraging law schools to introduce macroeconomic training as part of the standard curriculum. This is a seismic shift indeed, because the intellectual tools that Posner and the law and economics movement have contributed are all microeconomic. Perhaps this shift is not so puzzling: Posner is right to recognize (implicitly) that advanced training in microeconomics does not help us understand what caused the crisis. By contrast, nothing could be more systemic than macroeconomic theories, which treat the dynamics of the entire capitalist economy. On the other hand, Keynes’s General Theory, on which Posner relies, was published in 1936. The basic dynamics of capitalist economies may or may not have changed since then, but one thing that definitely has changed is the legal framework within which the finance industry works. Financial regulations are particular to a given country in a given year. They are constantly being amended and their details are crucial to the operation of the banking system at any given time. It is therefore at least conceivable that an adequate account of the financial crisis of 2008 will benefit more

from an inquiry into particular legal rules than from a recounting of a 73-year-old
“general theory” of business cycles, no matter how penetrating its insights might be.

The content of Posner’s book is divided into roughly three parts. The first is
devoted to a sequential analysis of both the proximate and deeper causes of the crisis.
Government reaction to the crisis, and the ensuing debates, are dealt with at length in the
second part. Finally, Posner offers a diagnosis and prediction as to the way forward, both
intellectual and in terms of public policy. While all three parts reward careful reading, my
main focus here will be on the first part, touching other elements only on-the-go, since the
causes of the crisis are poorly understood and an accurate grasp of them is necessary if
reforms addressed to systemic risk will achieve their objectives.

II. Posner’s Theory of the Crisis

A. Macroeconomics

If there is one sentence that serves as the nucleus of Posner’s theory, it is this: “The
culprit is cheap credit rather than irrational behavior by business or consumers.” In part
this is a declaration of Posner’s continuing loyalty to microeconomics, and therefore to
rational-choice theory. But it also incorporates Posner’s newfound Keynesian sensitivity
to the quandary facing rational actors when they confront an inherently uncertain future.
Posner discusses and dismisses a bucketful of allegedly “deeper” character or behavioral
flaws, such as irrational optimism and the stupidity of financiers (76-85). But he points
out that what might appear irrational and stupid in retrospect, such as buying a stock high
and selling it low, is better explained by our profound uncertainty about future events ex
ante than by ex post invocations of “irrationality” or by derivations, from the laboratory
settings of behavioral psychology, of the conclusion that any market error must be due to
the triumph of emotion over reason. No one, regardless of how emotionless or intelligent,
knew and could articulate beyond doubt either the probability or the eventual cost of the
meltdown. Investors and firms use inferences from the past, theories, and hunches to
make their best guesses about the point at which profit opportunities may turn into losing
propositions, but such forecasts are always attempts to peek behind the rigid veil of
ignorance that prevents absolute knowledge of the future.

In place of psychological speculation about why so many errors were made in the
years leading up to the crisis, Posner offers a structural analysis of the effects of cheap
credit.\footnote{Cheap credit and low rates of interest denote essentially the same concept – the ability of the borrower to obtain low-cost money, either for investment or consumption purposes. In the period of 1998 to 2005 interest rates on thirty-years mortgage fell from 7% to 5%. See Federal Home Loan Mortgage Corporation (FHLMC), 30-Year Fixed-Rate Mortgages Since 1971, available at http://www.freddiemac.com/pmms/pmms30.htm} Cheap credit provided the means to stimulate overall economic activity, “causing
asset prices to rise, including the prices of residential real estate – a huge part of the
nation’s asset base” (105). The recent history of rising asset prices, especially in housing,
created for many coolly rational observers the illusion that nothing was amiss. Among
these observers, Posner points out (253-254), were Alan Greenspan and Ben Bernanke,
both of whom noted that there had never been a significant nationwide real-estate bubble
(as opposed to local ones, which clearly were in progress in some cities), and who
attributed the general rise in home prices not to their own monetary policy of near-zero
interest rates, but instead to the influx of foreign capital and to the affluence of an ever-
growing American population, eager to spread out. As long as the illusion was sustained
by a prodigious flow of cheap credit, not only were consumers willing and able to borrow
more, but lenders were willing and able to satisfy their demand for debt.
Posner notices that there is nothing unique in this *general* pattern—an asset bubble following from an expansion of credit. Indeed, the pattern has been observed in all business cycles (105). But “the usual result is just a recession.” What served to bring about the great recession (which he insists that we count as a depression), Posner contends, was “a combination of a dearth of safe savings with a banking industry that is highly leveraged.” The lack of “safe savings” was important since, later on, “as a result of heavy losses caused by excessive leverage, [as] the [financial] industry pulls back from lending, consumers will have great difficulty borrowing to maintain their consumption, and a steep fall in personal consumption expenditures can tip the economy into deflation by precipitating deep price discounts” (106).

We can see Posner attempting here to meld his assumption that our recession has causes that can be captured in Keynes’s “general [macroeconomic] theory” with the obvious fact that this particular recession was triggered by a banking crisis. The “dearth of safe savings” constitutes Posner’s principal link between the Keynesian analysis of the “real” economy and the banking system. In a low-interest-rate environment, there is a dearth of investments that will produce more-than-negligible returns. One solution is to “leverage up” by borrowing some of the cheap credit that is sloshing around in the economy. One may thereby magnify the potential gains to be extracted from relatively low-yielding positions.

Posner’s analysis is mainly an elaboration of the mechanics of this process. His inroads into macroeconomic discussion are impressive but by no means without problems. This, however, is not the place for discussing the fine points of Keynesianism. The question is whether Keynesianism or any other macroeconomic theory is enough to connect the recession to the banking system in a manner that fits the facts. So, in what
follows, I will concentrate on what Posner says (and fails to say) about the leveraged banking system.

**B. Banking**

To understand the dynamics of events that led to the present “depression,” Posner insists, a proper grasp of banks’ central role is a necessary precondition. This role is captured in the economists’ term for banks: “financial intermediaries.” Financial intermediaries borrow money and then lend (or otherwise invest) it. They include hedge funds, mortgage lenders, trust companies, investment banks, and commercial banks.

Posner makes the odd claim that today’s “largely unregulated banking industry” renders these distinctions irrelevant, since the “repeal” of the Glass-Steagall Act in 1999 allowed commercial banks to operate simultaneously in banking and securities markets. What is odd about this claim is that there is not a country in the world with a “largely unregulated banking industry”—certainly not the United States, despite the “repeal” of Glass-Steagall (actually just an amendment to it). It is, to be sure, very commonly said by prominent economists, such as Nobel laureate Joseph Stiglitz, that the American banking industry is “largely unregulated,” but such commentators, no matter how eminent, are not expected to be specialists in financial law. They specialize in theoretical abstraction, of both the micro and the macro variety, not historical research into the details of banking law. But assertions about the degree of regulation sustained by the banking system are clearly assertions about banking law in a given period of history (ours), and in making the assertion that banking is largely unregulated, Posner is wrong.

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What may well explain this mistake, however, is Posner’s overly quick dismissal of the distinctions among the various types of bank. When it comes to the topic in which he is justifiably interested—the leverage of “the banks”—these distinctions remain very important. The banks that failed most spectacularly—Bear Stearns, Merrill Lynch, and Lehman Brothers—were all stand-alone investment banks. Now it is essentially (if not technically) true to say, as Posner does, that their leverage ratios were unregulated. It is also true that investment banks were typically very highly leveraged: in 2008, Bear Stearns was leveraged at more than 33:1, Merrill at 20:1, and Lehman at about 30:1. If there is indeed no distinction any more between investment banks and commercial banks, as Posner claims, then one might assume that such high leverage ratios were common across the entire banking industry.

But they were not. The aggregate leverage ratio of all banks, lumping together both commercial and investment banks—and therefore inflating the figure, due to the relatively high leverage ratios of investment banks—stood at about 8:1 on January 1, 2008, at the threshold of the crisis. A leverage ratio compares a bank’s loans and other investments to its capital. United States banking law does not permit the amount of capital held by a “well-capitalized” commercial bank to fall below 10%, yielding a 10:1 maximum leverage ratio at all times. But at the beginning of 2008, the aggregate capital

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7 The deregulation consisted in SEC permitting the five publicly held investment banks to be exempted from its traditional Net Capital Rule, which prescribed specific ratios of debt to equity. See Net Capital Requirements for Brokers or Dealers, 17 C.F.R. § 240.15c3-1 (2008). In its place, the five firms were allowed to design their own individualized credit models, which the SEC then could reject.


cushion of all American banks was 12.8%—down a mere two tenths of one percent from the end of 2003.

Now it is true that even the resulting 8:1 leverage ratio might be disastrously high if the assets in which banks were leveraged turn out to be bad bets. And we shall see that this is an accurate description of what happened. Thus, by pointing out the relatively low leverage level of commercial banks in comparison to investment banks, I do not mean to suggest that commercial banks’ leverage was not a problem. My point, however, is threefold. First, Posner may have been misled by the Glass-Steagall “deregulation” narrative into assuming that all banks’ leverage ratios after 1999 were essentially unregulated, as investment banks’ ratios were. This assumption abolishes by fiat the quite elaborate regulations—the Basel accords—that govern commercial banks’ leverage ratios in most of the industrialized countries of the world, including the United States. Second, these elaborate regulations may have impinged on the leveraging ambitions of individual banks, but they did not affect American commercial banks in the aggregate, which took a third less leverage than the legal ceilings allowed to them. This presents a major problem for Posner’s thesis, as we shall see, for Posner assumes that bankers were intent on taking the maximum possible risk in pursuit of financial gain. If that was their intention, then they should have driven leverage levels up to their legal maxima by driving capital cushions down to their legal minima, but as we have just seen, they did not. Third, then, the story of banks’ leveraging may not be something that can be captured in abstract reasoning, of the sort in which Posner engages, about the incentives that would have faced financial intermediaries in a totally deregulated world. Commercial bankers did not face a totally deregulated world: not just their maximum leverage levels but the composition of the assets purchased with leverage was governed by the Basel accords. If
bank leverage offers the key to understanding the crisis, we may have to understand the
details of the regulations that were based upon, and that amended, these accords. In the
details of these regulations—not in the absolute amounts of leverage that they allow—we
may well find the legal roots of the greatest economic crisis since the Great Depression.

If we agree with the fundamental law-and-economics thesis that the legal
framework matters, i.e., that it has consequences for economic behavior and, perhaps,
even for the economic system as a whole, then it is imperative, first off, that we know
what the legal framework is—in detail. Studying these details might be less sexy than
theorizing about “animal spirits” (or demolishing these theories, as Posner does
brilliantly); calculating spending multipliers; exploring the paradox of thrift; etc. But such
study is, arguably at least, even more important than macroeconomic theorizing.
Macroeconomics is a function of whatever conditions determine microeconomic
behavior, and among these conditions are not only psychological states, and the
uncertainty emphasized by Keynes, but legal rules. To say this is not to deny the benefits
of an interdisciplinary approach to understanding the crisis. But Judge Posner would be
the first to agree that the economics profession was unprepared for such an event and is
now in theoretical disarray. The tools of macroeconomic analysis deemed sound just a
year and a half ago turned out to be less than reliable. It is therefore far from self-evident
that the best step, or the first step, toward coping with the intellectual challenge that
lawyers, too, face—if they are to understand systemic risk—is to resurrect
macroeconomic tools that seemed solid seven decades ago, or for that matter eight
(Hayek’s), or thirteen (Marx’s), or fourteen (Mill’s). Perhaps we should not jettison the
traditional emphasis on the importance of the legal framework just yet.
C. Housing

The consensus view, with which Posner agrees, is that the roots of the financial crisis were sown in the subprime portion of the housing market. In many respects, Posner tells a comprehensive and enlightening story about this, with many key actors moving in tandem. But the basic problem is to explain why so much money was lent to subprime borrowers (and alt-A borrowers, and borrowers without documentation, and borrowers who made low down payments or none). In treating this topic, Posner does not begin with the basic mechanism for avoiding the waste of capital: the fear of losing one’s money.

In principle, we should find rational lenders being very careful to weigh (on the one hand) the risk of default on any given loan against (on the other hand) the interest the loan would command if repaid. No individual lender can significantly affect the market rate of interest. But absent regulation, a lender has discretionary power regarding who receives his loans. So if we find lenders handing out mortgage loans as if they did not care about default risk, it represents a microeconomic paradox.

One possible solution, embraced by Posner, is that rising house prices tended to negate the very possibility of default, since a borrower who later could not afford to make payments on the loan could always sell the house for a profit—as long as prices kept going up. Thus, a cornerstone of the conventional wisdom about the crisis has been that bankers were “irrationally exuberant” about the prospect that house prices would keep rising—forever. We have already seen, however, that Posner has no patience for irrationality theories. So what rationality-friendly theory can Posner use to square this circle?

Posner offers three explanations, two of which are somewhat at odds with each other. First, since the popping of a bubble is a matter of uncertain timing, the upside of a
bubble may contain enough profit opportunities to warrant continued investment in it, even after a banker suspects that he is betting into a bubble (91-92). Second, executive compensation in the form of golden parachutes, and compensation for lower-level employees in the form of bonuses, encouraged excessive risk taking. Neither the executives nor the employees who bought such securities as mortgage-backed bonds were penalized if their actions led to losses, but they were rewarded if their actions led to gains (92-98).

These first two of Posner’s three explanations have it both ways. The first explanation suggests that bankers late in the housing cycle were making reasonable bets that the cycle would continue long enough for their firms to profit unscathed from continued investments in it; the second suggests that they did not care about escaping unscathed because they were, in effect, being paid to ignore risk, even excessive risk. This second explanation has become widely accepted as true. It may be true; there is little research on it. An initial study by Rudiger Fahlenbrach and Rene Stulz\textsuperscript{11} found that banks whose executives held more bank stock did worse in the crisis than banks whose executives held less. This fact tends to affirm Posner’s first explanation while undermining the second, since it suggests that the executives were not choosing, for pecuniary reasons, to ignore excessive risks of which they were aware. If they had been aware of such risks, they would have sold their stock. But a more recent study by\textsuperscript{12} casts doubt on Fahlenbrach and Stulz’s findings.


In either case, however, Posner missed here an opportunity to transcend the theory-rich, evidence-free tendencies of mainstream economics: Whether executive-compensation schemes at the banks did or did not account for the bankers’ *ex post* excessively risky bets, it is odd that such perverse compensation structures were (and remain) in place at all. One explanation might be found in the work of Amar Bhidé, whose research suggests that the 1930s SEC regulations that, in effect, created the modern stock market shifted investment-allocation decisions to mass investors and their advisers, none of whom were allowed by law to have the inside access that had previously enabled intelligent investment decisions. Instead, investors now had, and continue to have, little choice but to rely on gross heuristics such as quarterly earnings estimates, which therefore skew corporate management to try to deliver short-term returns. Discovering whether these regulations are thus indirectly responsible for the now-derided executive-compensation systems at banks and other corporations would certainly be an important contribution for law and economics scholars to make.

D. Securitization

Posner’s third answer to the mystery of why bankers got themselves into so much trouble is that they thought they were offloading the risk by turning mortgages into mortgage-backed securities (MBS) and retaining only the least-risky slices of them. With securitization, Posner begins getting to the nub of the matter.

Securitization worked in the following manner. Commercial banks would sell their individual (“whole”) mortgages either to Fannie Mae and Freddie Mac or to investment banks, which pooled hundreds or thousands of mortgages into MBS. In the

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case of investment banks, these pools were then “tranche[d]” into bonds with different ratings (AAA, AA, A, BBB, and so on). Buyers of the triple-A tranche were contractually entitled to the highest priority when income was distributed from the mortgage and interest payments generated by the entire pool. If any of the mortgages in the pool defaulted, holders of bonds from the lowest-rated tranche would be the first to bear the loss. If enough mortgages defaulted, holders of bonds from the next-lowest-rated tranche would start to receive diminished payments, and so on, with the AAA tranche hit last. Due to this tranching system, all of the mortgages in a pool could be subprime (or alt-A, etc.), yet there would still be an AAA-rated tranche. The ratings did not indicate any differentiation within a mortgage pool between the risk levels of different types of mortgages (fixed-rate, adjustable-rate, low or high down payment, etc.) or the types of mortgagors (prime, subprime, no-documentation, etc.). All of the mortgages in the pool were treated the same: as income streams. The different ratings merely indicated the contractual order of priority by which these streams would be divided among different investors, with the “senior” investors, those possessing AAA bonds, being the last to suffer from any interruption in the stream of income from the entire pool. In exchange, however, these investors sacrificed the higher yield that always goes with riskier, lower-rated bonds.

Posner notes that commercial banks “tended to buy the top tier in each mortgage-backed security” (52), which is quite true: 81% of the mortgage-backed bonds issued by commercial banks were rated AAA.14 But the banks’ preference for these bonds produces a quandary for Posner’s theory. There is nothing inherently better about holding an AAA

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bond instead of a BBB bond. The lower risk of the AAA bond brings with it a lower rate of return, precisely because it is less risky than the BBB bond. In passing up lower-rated MBS, banks were passing up higher returns. Yet the heart of Posner’s theory is the notion that banks wanted to increase their leverage—and thus their risk level—so as to drive up their returns. He writes:

“We should consider why a lender would want to make a risky loan. The basic reason is that the greater the risk, the higher the interest, to compensate the lender for the possibility that the borrower will default and as a result the lender will not be repaid.”

Why, in that case, would the same risk-and-interest-seeking lender buy less-risky, lower-yielding, triple-A bonds instead of higher-yielding, riskier triple-Bs? If a lender wanted higher risk and the compensating higher return, it was available in the form of lower-rated tranches of an MBS. Yet the lenders overwhelmingly chose the higher-rated, safer, less-lucrative tranches.

It is true that in doing so, the lenders offloaded much of the risk of a popped housing bubble (although not enough of it, in the end) to the purchasers of lower-rated tranches. But lenders did this at the cost of the very quest for revenue, heedless of risk, that was, according to Posner’s third (and second) hypotheses, driving the banks’ lax lending policies in the first place.

Therefore, we are left with Posner’s first theory, that bankers were betting on the continued inflation of the housing bubble, and on their ability to extract themselves from this bet before the bubble burst. This is conceivable, but it leaves an even bigger
quandary: Why did commercial banks, among all of the world’s investors, place such a heavy bet on the housing bubble? Commercial banks were in the best position of anybody to know about the underlying fragility of the bubble, especially inasmuch as they often issued the subprime mortgages that formed the weakest part of the housing market. Yet no other class of investors—not hedge funds, not pension funds, not mutual funds, not insurance companies—so dramatically overinvested, and, indeed, overleveraged, in mortgage-backed bonds. Why?

III. Bank Leverage and Capital Regulations

To answer such questions, we have to leave Posner’s theory behind, even though his discussion treats the general subject of bank leverage in a sophisticated and enlightening fashion.

This discussion quickly identifies the inherent riskiness and fragility of the (commercial) banking business. Banks are not only big lenders they are also big borrowers; their creditors are depositors, who put money into checking or savings accounts. Most of the money that a bank takes in from these depositors is lent out at interest to borrowers, such as mortgage holders or commercial businesses seeking to expand; or it is invested in securities, such as mortgage-backed or corporate bonds. The income from these loans and investments is the source of a bank’s profit. So a bank is inherently leveraged: Its income comes from funds borrowed from depositors (which is then lent or invested).

This situation gives rise to the need for a capital cushion. The more of a commercial banks’ depositors’ borrowed funds are lent out to other borrowers, or are invested, the more money a bank makes (ceteris paribus). But the bank needs to keep a
cushion to cover unexpected withdrawals by depositors—as used to occur during bank runs. A bank also needs a capital cushion to cover the possibility that borrowers, such as mortgage holders, will default on their loans—a matter that is usually predictable within certain bounds, but not always, as the financial crisis reminds us. And since a bank’s funds are borrowed, it needs a cushion against the possibility that its investments will not turn out as hoped. Otherwise, a bank would be in the position of the stock-market investors who famously used borrowed funds to bet on equities just before the stock market crash that touched off the Great Depression. These are the investors who jumped out of windows because they had nothing to cover their highly leveraged losses.

As a rule, the greater a bank’s capital cushion—thus, the lower its leverage—the lower its risk of bankruptcy. But at the same time, the greater the capital cushion, the less profitable the bank (ceteris paribus), because less of its money is being lent out or invested at interest. Balancing risk and return is the most fundamental challenge that bankers—and banking regulators—face. Posner explains this very well, but then he says nothing about the actual bank-capital regulations that were in place before and during the crisis (the Basel accords), which directly regulate the amount and, crucially, the composition of commercial banks’ leverage.

The long history of bank failures and financial panics that occurred periodically since the beginning of the 19th century prompted numerous efforts at regulation and legal supervision of the banking system. Posner provides only a very sketchy history of the many reforms that followed, of which bank-capital regulations were the most important. Whenever and wherever deposit insurance has been instituted, as it was in the United

States in 1933, it has been accompanied by bank-capital regulation, since the financial regulators have feared that otherwise, banks that were now insured against bank runs by the government might be tempted to shrink their capital cushion too low to cover unanticipated losses on their loans (or other investments).

Eventually, in 1988, the bank-capital regulations of the G10 countries (and very quickly those of most other countries) were harmonized by guidelines agreed upon by the Bank for International Settlements’ Basel Committee on Banking Supervision. The first set of Basel accords, now known as Basel I, was agreed to in 1988; a new set of much more detailed and complex recommendations, Basel II, was issued in 2004. The Bank for International Settlements has no authority to impose its recommendations on anyone, however, and each country introduces them in its own fashion. In the United States, Basel I did not take effect until 1992, and Basel II did not begin to be implemented until 2008, although it was implemented earlier, starting in 2006, in the rest of the world.

In the interim, in 2001, the Federal Reserve Board, the FDIC, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision issued an amendment to Basel I—the Recourse rule—which took effect on January 1, 2002, a date that, not coincidentally, might be said to mark the beginning of the housing boom. Basel I had distinguished between different asset classes according to their (presumed) riskiness, and required different amounts of capital to be held against them accordingly, up to 8%. In the

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16 Public No. 66, 73d Cong., H. R. 5661.
18 Basel I aimed only at providing adequate capital to guard against the credit risk associated with a bank’s loanbook. It did not take into account interest rate risks, currency risks and risks from overall macroeconomic fluctuations. The Basel Committee left the G10 governments with the task of dealing with the latter category of risks, which for the most part varied greatly across the countries.
20 66 FR 59614.
United States, the financial regulators made the base capital cushion higher—10%, as previously mentioned—for banks desiring the important legal privileges that came with being categorized as “well capitalized.”

Under Basel I, gold, cash, and government bonds held by a commercial bank received a 0 percent risk weight, so they required no capital cushion. But whole mortgages received a 50% risk weight, requiring a 4% capital cushion (.50 x 8%). Commercial loans, corporate bonds, and equities received a 100% risk weight, requiring an 8% capital cushion. To this list, the Recourse rule of 2001 added asset-backed securities, such as bonds backed by pools of credit-card debt, bonds backed by pools of automobile loans—or bonds backed by pools of mortgages—that had received an AA or AAA rating. These securities received a 20% risk weight, requiring a 2% capital cushion for “well capitalized” banks (.20 x 10%). This American innovation was spread to the rest of the world by Basel II.

The result of this innovation in the United States was that, as of January 1, 2002, commercial banks were required to hold 80% more capital against commercial loans, 80% more capital against corporate bonds, and 60% more capital against whole mortgages than they were required to hold against mortgage-backed securities, as long as these securities were rated AA or AAA. Thus, for example, a bank could receive 60% “capital relief” by exchanging whole mortgages for mortgage-backed bonds with high ratings. Each such exchange would free up 60% more capital for a bank to lend out or to invest at interest; to put it slightly differently, it would reduce the bank’s capital cushion that had been held against those whole mortgages by 60%; or, to use Posner’s preferred usage, it would give the bank 60% more leverage—if a bank wanted to take it.
The Recourse rule did not change the base level of capitalization, hence the level of leverage, that was required of American commercial banks. This remained 10% for well-capitalized banks. But to the extent that a bank wanted more rather than less leverage, the Recourse rule would make that bank 80% more inclined \((ceteris paribus)\) to achieve it by buying mortgage-backed bonds (or other asset backed-securities) instead of corporate bonds, 80% more inclined to achieve it by buying mortgage-backed bonds (or other asset backed-securities) instead of making commercial loans, and 60% more inclined to achieve it by buying mortgage-backed bonds (or other asset backed-securities) instead of (or in exchange for) whole mortgages. The Basel rules, as amended in 2001 by the American financial regulators, therefore can be expected to have drastically altered not the amount of leveraged assets that so concerns Posner, but the composition of it. And it was this composition—the high concentration of mortgage-backed bonds held by commercial, not investment banks—which directly precipitated the financial crisis when, in September 2008, unexpectedly high default rates in subprime mortgages called into question the safety of the huge inventory of mortgages held by Lehman Brothers, which was pooling them for sale to commercial banks (and other investors).

Lehman’s bankruptcy called into question the solvency of all the commercial banks that had bought mortgage-backed bonds. This led to a lending freeze both among commercial banks and between them and the real economy, as each bank was afraid that its counterparties’ balance sheets might be so full of possibly-worthless mortgage-backed bonds that loans to them might never be repaid; or that a bank’s own balance sheet might be so full of possibly-worthless mortgage-backed bonds, that a bank might be unwise to lend funds into the real economy that might be needed by the bank to prevent its own
insolvency. These were matters of uncertainty because nobody knew how far house prices would decline, and thus the ultimate fate of mortgage-backed bonds.

Arguably, without the overconcentration of mortgage-backed bonds in American commercial banks, there would have been no financial crisis and no worldwide recession. Therefore, an account of the financial crisis needs to explain why banks alone, among all classes of potential investor, had bought so disproportionately many mortgage-backed bonds. Posner does not offer such an explanation. The Recourse rule does.

I do not mean to imply that the Recourse rule was the sole cause of the financial crisis. It might have been necessary, yet it might not have been sufficient. Moreover, the crisis was international in scope, and the Recourse rule affected only American banks. On the other hand, Basel I applied internationally, and it encouraged “regulatory arbitrage” all over the world by means of off-balance-sheet investments in AA and AAA rated securities held in “structured investment vehicles” and other entities, which were funded in the short-term commercial paper market.\footnote{Viral V. Acharya & Philipp Schnabl, How Banks Played the Leverage Game, 89 (83-100), in Restoring Financial Stability: How to Repair a Failed System (Viral V. Acharya & Matthew Richardson eds., 2009).} Moreover, Basel II, which followed the example of the Recourse rule, began to be implemented internationally in 2006. All of this is a matter of law, and should be of interest to scholars of law. It is also a matter of the economic effects of law, and thus should be of particular interest to scholars of law and economics.

Nor have I touched on other legal influences on bank capital. For instance, SEC pressure had long been brought to bear against banks that built up “too much” capital against loan losses, which surely must have reduced banks’ overall capital level compared
to what it might have been. Nor have I discussed regulatory and statutory contributions to the housing boom itself.

Nor have I discussed a related question: Who gave mortgage-backed bonds their AA and AAA ratings? The answer is the three “rating agencies,” which are actually publicly held profit-making corporations: Moody’s, Standard and Poor’s, and Fitch. In 1975, the SEC had amended its Net Capital Rule to establish that for legal purposes, only the bond ratings of “Nationally Recognized Statistical Rating Organizations” (NRSROs) were acceptable. By naming the three incumbent bond raters as the only NRSROs, this SEC action conferred an oligopoly on these three corporations. Only an AA or AAA rating from an NRSRO counted as legitimate under the Recourse rule—and under a host of other financial regulations, such as those covering the commercial-paper market. Shielded from competition, the rating agencies worked hand in glove with the investment banks to eke out of each MBS the biggest conceivable triple-A (and double-A) tranches, a service for which they were handsomely rewarded. However, the rating agencies failed to anticipate the high default rates that would emanate from the red-hot mortgage market, subprime included. Moody’s, for example, did not update its statistical model for mortgage defaults after 2002.

26 See Lawrence J. White, The Credit Rating Agencies and the Subprime Debacle, 21 Crit. Rev. 391, 389-399 (2009). For a more detailed discussion of the history, the record as well as recent approaches to improve the performance of the credit rating agencies, see Caitlin M. Mulligan, From AAA to F: How the Credit Rating Agencies Failed America and What Can be Done to Protect Investors, 50 B.C. L. Rev. 1275 (2009).
27 White, supra note at 395.
28 Id. 397-398.
The sloppy and perhaps avaricious behavior of a legally protected oligopoly would not surprise any economist, but Posner does not mention the legal protection of this oligopoly. But then again, he does not mention any of the other regulations governing banking, housing, or securities that had remained untouched by the selective deregulation of finance, which had ended in 1999.

IV. Historical Legal Research and Systemic Risk

Instead of targeting any of the regulatory factors I have listed, or any of the statutory or regulatory laws governing the housing market, Posner turns to macroeconomic factors to explain the crisis, and he advises lawyers to do the same if they wish to understand systemic risk—as indeed they should. I have barely touched on macroeconomic factors, such as low interest rates; and any comprehensive examination of the housing boom must at least consider them. But the housing boom, and the subsequent bust, are not coextensive with the financial crisis. The housing bust caused panic among the banks about their own solvency, but only because they had become so overinvested in MBS. If regulatory law can account for this, then it would seem only natural for legal scholars to be leaping at the chance to expand the frontier of their discipline not just by learning macroeconomics, but by researching the economic effects of the immense body of regulatory and statutory law—local, state, federal, and now international—that has grown up over the last two centuries.29

It might seem that such research would be of largely antiquarian interest, especially in the case of laws that have been superseded, and could not help us deal with contemporary problems such as systemic risk. Thus, one might think that even if my

argument here has been correct, all we need to know about what caused the crisis is captured in an historical net that extends back a mere nine years, to when the Recourse rule was promulgated. But even setting aside the provisions of Basel I (1988) that encouraged off-balance-sheet mortgage-backed security purchases by commercial banks, we need to understand why the Recourse rule, hence Basel II, were thought by the regulators to be desirable correctives to Basel I—lest we inadvertently repeat their thoughts, which proved to be so wrongheaded, in designing Basel III or other preventive measures. The same reasoning would compel us to try to understand why the SEC amended its Net Capital Rule in 1975.

But that is just the start of it. In light of thesis I have presented here, how might one go about regulating bank capital in a manner that would eliminate the systemic risk that was introduced by the differential treatment of different asset classes, such as asset-backed securities? Should we refine this treatment even further, taking the risk that other unexpected developments will render a privileged asset class particularly dangerous? Recall that all the way through, the Basel accords have given a zero risk weight to cash, gold, and government bonds. This might cause another worldwide financial collapse if inflation erodes the value of cash or bonds, or if there is an asset bubble in gold. Yet which securities could be safer than these, \textit{ex ante}?

To lift a page from Posner, this is a question that bankers confront daily, in the following form: When will the risks of an uncertain future turn a profitable asset into a loss? All risk-weightings of capital requirements are, in effect, attempts to outguess various bankers’ answers to that question. Perhaps such an enterprise is hubristic. But in that case, should we return to the blunt capital requirements, insensitive to risk levels, that

\begin{footnotesize}
\begin{thebibliography}{99}
\item Gillian Tett, \textit{Will Sovereign Debt Be the New Subprime?}, \textit{Financial Times}, November 23, 2009
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were first imposed after the dawn of deposit insurance? Here, again, it would be useful to know the reasoning of the regulators who introduced risk differentiation into bank-capital rules. Moreover, even simple minimum-capital requirements will not be so simple when we have to define what counts as “capital” and when we set the levels. As we have seen, American bankers before the crisis were, in the aggregate, far less leveraged (8:1) than the law allowed them to be (10:1). Should we raise the minimum capital level above the 12.8% aggregate figure at which it stood on the eve of the crisis? Twenty percent? Thirty? Why not 100%? That would ensure systemic stability, but at the cost of a tremendous amount of economic growth. (Moreover, we need to remember that the higher the capital cushion, the less profitable the bank.) Real stability might be achieved by banning all lending. But it would be the stability of medieval economic stagnation, before the invention of banking.

However, with even more historical enlightenment, we might conclude that this whole approach to banking regulation is unsound. We know from the official history of the FDIC that bank-capital regulations were deemed necessary to address what would now be called the “moral hazard” that had been created by the institution of deposit insurance in 1933. Perhaps, then, we would not need bank-capital regulations if we did not have deposit insurance. But don’t we have to have deposit insurance if we are to prevent bank runs and panics? Not necessarily. Here is Gary Gorton’s treatment of the question, in the context of his own call for historical research into the particularities of legal regulation:

Panics do not occur under all institutional settings or under all security designs. Contrary to most of the theoretical literature, historically it does
not appear that panics are an inherent feature of banking generally. This point has been made by Bordo (1985, 1986), Calomiris and Gorton (1991), and Calomiris (1993), among others. Bordo (1985), for example, concludes that “the United States experienced panics in a period when they were a historical curiosity in other countries” (p. 73). Indeed, the same observation was made a century ago, by Andrew (1908A): “In England no such general suspension of bank payments and no such premium upon money have occurred since the period of the Napoleonic wars; in France not since the war with Prussia…” (p. 290-91). Why is this point important? If one shares the viewpoint that panics are inherent to banking, then the details of panics perhaps do not matter. My viewpoint is that understanding panics requires a detailed knowledge of the setting.\(^{31}\)

In other words, our assumptions about the causes of the problems we are trying to address may be wrong, and historical research might reveal this.

It might reveal, for example, what it was about the United States that made it so susceptible to bank runs throughout the nineteenth century and the Great Depression—experiencing thirteen from 1793 to 1933, while Canada (which did not adopt deposit insurance until 1967) experienced only three, and none during the Depression.\(^{32}\) What might account for this difference in systemic risk? Since both Canada and the United States were capitalist countries (and contiguous ones), no general theory of


macroeconomics or banking is likely to reveal the answer. The key difference may have been the presence of legal restrictions on branch banking in the United States but not in Canada. So, having now abolished these restrictions, we might not need deposit insurance, and therefore we might not need to regulate bank capital. Since (I have argued) bank-capital regulations caused the crisis, perhaps the best way to reduce the risk of future crises is to abolish these regulations instead of tinkering with them.

That might seem a counterintuitive approach to systemic risk management. It is certainly the opposite of Posner’s approach. Since he sees the crisis as having been caused by an innate proclivity toward excessive risk taking among bankers, he assumes that they need to be even more tightly regulated than they already are. But we have already seen that the evidence refutes the notion that bankers were knowingly taking excessive risks—had they been doing so, they would have driven their capital cushions down to the legal minimum; and they would hardly have been so keen on buying mainly the least risky, least lucrative mortgage-backed securities they could find, the ones rated AAA. If the Basel rules, particularly the Recourse rule, were responsible for the bankers’ interest in mortgage-backed securities to begin with, then we may safely say that in the absence of these rules, the worst systemic crisis since the Great Depression would not have occurred. And perhaps the idea of responding to this information by abolishing bank-capital regulations is not so counterintuitive, after all. If we seek the causes of systemic risk, what better place to look than in the legal rules that govern the system as a whole?

V. Conclusion

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Written by one of the most versatile social scientists of our time, *A Failure of Capitalism* is a multifaceted contribution to our understanding of the great recession. But, due to its overwhelmingly macroeconomic character and substance, the nuanced approach of the law and economics scholarship is virtually absent, and so is any plausible explanation of the financial crisis that touched off the great recession. This is puzzling, because attention to the economic consequences of the law seems to provide a much more powerful framework for understanding what caused the financial collapse, and it is a natural approach for scholars of law and economics to pursue.