

DODD-FRANK, LIABILITY STRUCTURE, AND  
FINANCIAL INSTABILITY CYCLES:  
NEITHER A (PONZI) BORROWER  
NOR A LENDER BE

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INTRODUCTION

The financial sector has by now mostly sprung back from the crisis that began in 2007, as have corporate profits; but the labor market still sags, mortgage credit is scarce, and the future prospects for the economy, while not bleak, are not rosy either. Seeing this ongoing harm to the real economy caused by financial activities, Congress enacted the Dodd-Frank Act (“Act”) with an eye to limiting future financial instability.<sup>1</sup> The Act hopes to do this by updating financial regulation and creating better incentives for the private sector.

To see how the crisis developed and whether the Act will work, we need to understand how financial instability develops in capitalist market systems like ours. Economist Hyman Minsky claimed that the financial sector in capitalist market systems tends to chase returns by gorging on risk until its own financial structure becomes unstable, leading to a crisis like the last one that started in 2007.<sup>2</sup> The claim—known as the financial instability hypothesis—merits our attention because, though critical of the financial sector, evidence for it is derived from observing how banks actually operate over the business cycle.

I use the hypothesis in Part I to show what animated the last corporate leverage cycle: escalating expectations for profit financed on progressively riskier credit terms. In fact, the hypothesis belongs to a larger critique of conceptual approaches that deny the intrinsic

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

2. John Cassidy, *The Minsky Moment*, NEW YORKER, Feb. 4, 2008, at 19.

instability of capitalist market systems, so I also use Minsky's work to challenge claims made by nabobs of neoliberal negativism who are resisting the implementation of the Act. Part II addresses two aspects of the Act that bear directly on how the financial sector creates potentially destabilizing liabilities: (i) new requirements that leverage caused by financial swaps be margined and cleared; and (ii) a new mandate that federal regulatory capital requirements go in the opposite direction of the boom-bust dynamics characteristic of the business cycle.

### I. LIABILITY STRUCTURES DO MATTER

Hyman Minsky was an economist trained at Harvard in the 1940s under economic historian Joseph Schumpeter.<sup>3</sup> His theoretical work on the financial system was informed not only by the then recent memory of the Depression but by his service as a bank director.<sup>4</sup> Minsky observed that “[i]t turns out that the fundamental instability of a capitalist economy is a tendency to explode—to enter into a boom or ‘euphoric’ state,” followed by a bust.<sup>5</sup> When times were good, he said, firms took on riskier debt to invest in speculative assets, an unsustainable strategy that would lead, in time, to a crash.<sup>6</sup> He believed that government policy could contribute to the long term viability of capitalism by slowing down these boom-bust cycles.<sup>7</sup> Doing this would mean going against prevailing market sentiment.

Minsky's conceptual framework was not widely received by the academic establishment of his day, which followed the direction of Platonic quantitative modeling that assumed away the grittiness of economic life.<sup>8</sup> The last crisis painfully illustrated the financial instability hypothesis, which is now being reappraised and adopted more widely. As before, though, the idea that the government should actively intervene in the financial market faces renewed political opposition.

#### A. *Borrowing by Firms*

Minsky's analysis starts by looking at a firm's balance sheet, an

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3. See James S. Earley, *Joseph Schumpeter: A Frustrated “Creditist,”* in *NEW PERSPECTIVES IN MONETARY MACROECONOMICS: EXPLORATIONS IN THE TRADITION OF HYMAN P. MINSKY* 337, 338 (Gary Dymksi & Robert Pollin eds., 1994).

4. Cassidy, *supra* note 2.

5. HYMAN P. MINSKY, *Financial Instability Revisited: The Economics of Disaster*, in *CAN “IT” HAPPEN AGAIN? ESSAYS ON INSTABILITY AND FINANCE* 117, 118 (1982).

6. See *id.* at 122–24.

7. See HYMAN P. MINSKY, *Capitalist Financial Processes and the Instability of Capitalism*, in *CAN “IT” HAPPEN AGAIN?*, *supra* note 5, at 71, 86.

8. See generally Gary Dymksi & Robert Pollin, *Introduction*, in *NEW PERSPECTIVES IN MONETARY MACROECONOMICS*, *supra* note 3, at 1–18.

accounting report that estimates a firm's net worth for a given moment in time by subtracting what the firm owes to creditors from what the firm owns and is owed by others. Assets are the firm's claims on others. Liabilities are what the firm owes to others. Assets minus liabilities leaves what belongs to owners, called "equity." In the analysis, liability structure as a whole is central because it suggests how much and when the firm will face demands for payment, which must be settled with liquid resources or refinanced with another liability.<sup>9</sup>

Among firms in general, the liability structure of those that borrow to lend—so called "financial intermediaries"—is particularly telling of potential troubles because these firms influence how nonfinancial firms fund themselves. A manufacturing or a services firm will have financial items—liability and equity—on the right-hand side of its balance sheet, but a financial intermediary has financial claims on both sides of its balance sheet because it invests borrowed money in the liabilities of other firms.

Commercial banks are the typical example of a firm that borrows to lend, but if we define lending functionally then investment banks, hedge and private equity funds, pension funds, sovereign wealth funds, and other pools of investment capital are also financial intermediaries. Like all firms, they leverage themselves, borrowing to increase their ability to invest in other firms, both financial and nonfinancial ones. Leveraging is a fact of business life, but when a firm borrows too much, it risks its solvency and its ability to honor contracts to others, because the firm's liability structure becomes unsustainable.

Minsky saw a troubling pattern in the liability growth of firms that borrow to lend. Again and again, their balance sheets would become more fragile because they took on more debt and borrowed on deteriorating credit terms.<sup>10</sup> This cycle took place during good times as firms would borrow at more speculative rates so as to hunt for return in riskier investments, adding fragility to both sides of the balance sheet. The rub was that these firms had to re-enter the credit market to refinance liabilities. This was fine when interest rates were stable, but tighter money meant certain loss when refinancing at higher rates. Now that serial refinancing and secondary trading are more common in the credit market, this analysis is more relevant than ever.

He classified debt into three types based on its propensity to require future refinancing, even in a rising interest rate environment: hedged, speculative, and Ponzi.<sup>11</sup> In hedged

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9. See HYMAN P. MINSKY, *STABILIZING AN UNSTABLE ECONOMY* 165–67 (1986).

10. *Id.* at 213–20; see José Gabilondo, *Leveraged Liquidity: Bear Raids and Junk Loans in the New Credit Market*, 34 J. CORP. L. 447, 475–76 (2009).

11. See MINSKY, *supra* note 9, at 206; Gabilondo, *supra* note 10, at 471–74.

borrowing, the borrower could pay all maturing interest and principal payments from the cash flow proceeds of the investment made with the borrowed funds.<sup>12</sup> In speculative borrowing, the borrower could pay only interest from investment proceeds without refinancing, having to re-enter the market to refinance some amortization of principal.<sup>13</sup> The riskiest of the three was Ponzi borrowing because the initial terms of the debt meant that the borrower would have to re-enter the credit market for all contractual payments of interest or principal.<sup>14</sup> So there is nothing shady per se about Ponzi finance—it simply assumes that investment return will keep escalating, which can be true for a while but not forever. The distinction matters because many financial assets have useful lives longer than an investor's holding period, so the asset's longer-term value matters, especially on re-transfer.<sup>15</sup>

This classification focuses on the borrower to emphasize its liability structure. But it can also sort the lender's loan assets by their risk from refinancing. For an asset to be deemed hedged, it would have to be serviced from a dedicated income stream produced by the investment of the loan proceeds. If the lender assumed that the borrower would have to refinance some of the principal payments—perhaps by further borrowing from the lender, as is common with home equity lines of credit when the principal begins to amortize—then the loan would be a speculative asset on the lender's balance sheet. If the lender knew that the borrower would need to refinance during each scheduled payment period, then the loan asset would be Ponzi to both the lender and the borrower.

As the cycle accelerated during the last crisis, firms borrowed and lent at increasingly speculative and Ponzi terms, setting up their balance sheets for loss in the event that market prices ever stopped escalating, which they always do. And when they did, this fragility would devolve into a crisis in which financial promises could not be kept on a grand scale, a so called "Minsky moment."<sup>16</sup> Citigroup's chief executive officer Charles Prince said it best: "As long as the music is playing, you've got to get up and dance."<sup>17</sup> The result was borrowing and lending yourself (and others) into financial instability.

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12. See MINSKY, *supra* note 9, at 206–07.

13. *Id.* at 207.

14. *Id.* at 207–08.

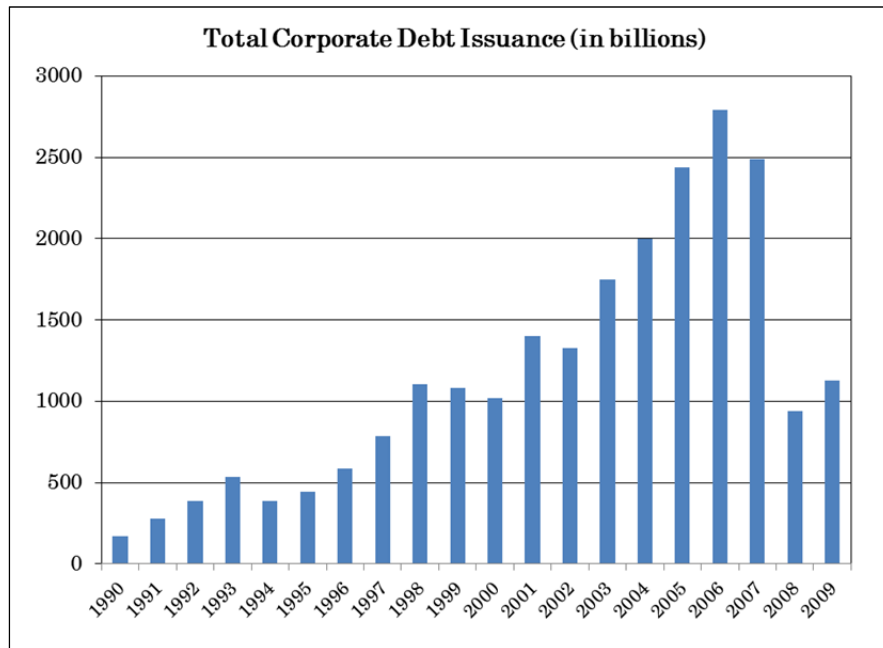
15. *Id.* at 174.

16. Justin Lahart, *In the Time of Tumult, Obscure Economist Gains Currency*, WALL ST. J., Aug. 18, 2007, at A1.

17. The whole quote is even more troubling because it knowingly discounts the liquidity crashes that are in the making: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance." Michiyo Nakamoto & David Wighton, *Bullish Citigroup is 'Still Dancing' to the Beat of the Buy-Out Boom*, FIN. TIMES, July 10, 2007, at 1.

The fragility cycle in the financial crisis of 2007 emerges in time series data of the Securities Industry and Financial Markets Association.<sup>18</sup> Figure 1 compares gross corporate debt issuance from 1990 to 2009 by firms, both financial and nonfinancial. The increase in debt issuance starts in 2000. After peaking in 2006 (the last full year before the crash), issuance dropped, with the low numbers in 2008 and 2009 reflecting the challenges firms faced in raising new debt capital after the crash.

FIGURE 1



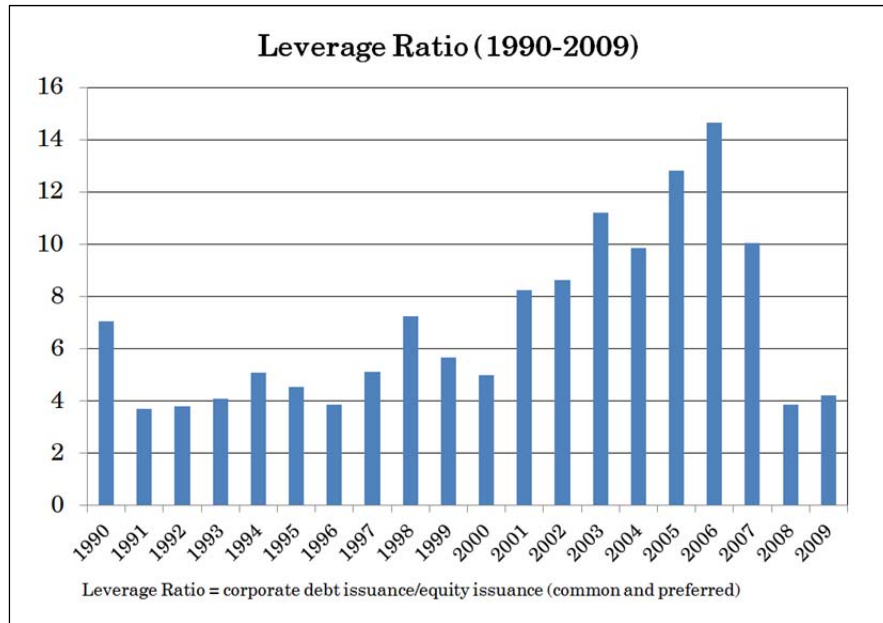
Gross debt issuance tells only part of the story. A firm with enough equity can sustain a corresponding debt load, even during periods of financial stability. It is rising leverage that adds up to financial instability.<sup>19</sup> So Figure 2 tracks leverage trends by dividing the amount of debt that corporations issued by the equity capital raised during the same period. Between 1990 and 2001, the leverage ratio ranged from between 4:1 and 6:1, suggesting the “old normal.” During 2001, the Federal Reserve began to tamp down

18. *U.S. Corporate Issuance*, SEC. INDUS. & FIN. MKTS. ASS'N, <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/CM-US-Key-Stats-SIFMA.xls> (last visited Aug. 30, 2011). Borrowing by households and government units also contributed to these conditions, but this Article focuses only on borrowing by private business units.

19. See, e.g., MINSKY, *supra* note 9, at 220–21.

interest rates,<sup>20</sup> and from then on, easy money fed the cycle, which peaked in 2006. That year, corporations issued fourteen dollars of debt for every dollar of equity—double and, in some cases, triple the leverage ratios of the old normal.

FIGURE 2



The financial correction originated during the third quarter of 2007 as markets began to be spooked, and by the end of that year the leverage ratio had dropped to 10:1. During the heart of the financial crisis, in 2008 and 2009, the ratio was back to the old normal, although it feels like deprivation after the bubble.

Insofar as they were securitized into private-label mortgage-backed securities bought by commercial banks, some of these liabilities ended up on the balance sheet of the Federal Reserve (“Fed”). Doing just what a central bank should, the Fed lent money against collateral and bought bank assets outright during the crisis, although the ultimate quality of some of these acquisitions remains to be seen.<sup>21</sup> As a result, the Fed’s financial structure morphed. Figure 3 compares its balance sheet in March 2007<sup>22</sup> (before the

20. *Historical Changes of the Target Federal Funds and Discount Rates*, FED. RES. BANK OF N.Y. (last visited Aug. 30, 2011), <http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html>.

21. Sudeep Reddy & Anusha Shrivastava, *Fed’s Lending Ebbs as Crisis Subdues*, WALL ST. J., July 20, 2009, at A2.

22. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *Consolidated Statement of*

trouble started) with those of March 2009<sup>23</sup> and March 2010,<sup>24</sup> after the Fed's liquidity and credit programs had been largely completed. During this period, the Fed's leverage ratio increased from 27:1 to 44:1.

FIGURE 3  
TRENDS IN FED BALANCE SHEET COMPOSITION (IN MILLIONS)

	2007	2009	2010
<b>Total Assets</b>	\$873,681	\$2,073,227	\$2,316,525
Securities held outright	\$780,890	\$761,295	\$2,017,955
U.S. Treasuries	\$780,890	\$474,746	\$776,667
<b>Total Liabilities</b>	\$841,066	\$2,027,045	\$2,263,487
Deposits from depository institutions	\$18,429	\$822,412	\$1,147,747
<b>Total Capital</b>	\$32,615	\$46,182	\$53,037
<b>Leverage Ratio</b> (Leverage ratio is calculated by comparing <b>Total Capital to Total Assets</b> )	1:27	1:45	1:44

During this period, the asset portfolio of the Fed more than doubled, while the credit quality and liquidity of the assets declined. In 2007, U.S. Treasury securities were almost 90% of the Fed's asset portfolio.<sup>25</sup> By 2010, they made up only 33% as the Fed acquired investments in private-label mortgage-backed securities ("MBS"), which were then trading at a steep discount.<sup>26</sup> Though riskier than Treasury securities, these investments are not themselves subprime, as they tend to be super-senior investment-grade rated tranches of MBS.<sup>27</sup> This means that junior tranches in these MBS

*Condition of All Federal Reserve Banks, in* FEDERAL RESERVE STATISTICAL RELEASE H.4.1 (Mar. 29, 2007), available at <http://www.federalreserve.gov/releases/h41/20070329/h41.pdf>.

23. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *Consolidated Statement of Condition of All Federal Reserve Banks, in* FEDERAL RESERVE STATISTICAL RELEASE H.4.1 (Mar. 26, 2009), available at <http://www.federalreserve.gov/releases/h41/20090326/h41.pdf>.

24. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *Consolidated Statement of Condition of All Federal Reserve Banks, in* FEDERAL RESERVE STATISTICAL RELEASE H.4.1 (Mar. 25, 2010), available at <http://www.federalreserve.gov/releases/h41/20100325/h41.pdf>.

25. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 22 (percentage derived by dividing current "U.S. Treasury" securities by "Total assets").

26. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 24 (percentage derived by dividing current "U.S. Treasury" securities by "Total assets").

27. See generally MKTS. GRP. OF THE FED. RESERVE BANK OF N.Y. ORK, MARKETS GROUP OF THE FEDERAL RESERVE BANK OF NEW YORK, DOMESTIC OPEN MARKET OPERATIONS DURING 2010, at 11–16 (Mar. 2011), available at

will be the first to shoulder losses if borrowers default on the underlying loans. Time may show that the market discounted their value too much, giving the benefit of the bargain to the Fed.<sup>28</sup> In this case, it will be the taxpayer who benefits—the Fed is a proxy for the country's general fund because each year, the central bank transfers its net profit to the Treasury, which, in a corporate finance sense, is the Fed's residual claimant.<sup>29</sup>

As the Fed took on these new assets, its own leverage spiked since it funded its balance sheet growth by borrowing, mainly through taking deposits of commercial banks. In 2007, these deposits made up just over 2% of the Fed's liability base.<sup>30</sup> By 2010, they had increased sixty-fold, amounting to 50% of the institution's liability base.<sup>31</sup> In large part, these deposits represent resources that the Fed had made available to banks through stabilization programs. Even commercial banks know that few things feel as good as money in the bank, so they deposited these resources rather than making new loans to firms and individuals, which would have created new loan assets for these banks.

Though it seems to be a monolith, the new Fed is best understood as a complex of separate balance sheets, each with its own distinct asset-liability schedule and an ad hoc governance regime that serves different public purposes.<sup>32</sup> With respect to the special-purpose balance sheet created by taking on the private label MBS of commercial banks, the central bank lent its balance sheet to the banks by letting them substitute a Fed-backed asset with no credit risk but some inflation risk (the bank's Fed deposit) for the private label MBS about which a panicked market was being finicky. In effect, this on-balance sheet venture takes the place of a

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<http://www.newyorkfed.org/markets/omo/omo2010.pdf> (describing the Fed's complete portfolio at the close of 2010).

28. Jerry Markham, *Regulating Credit Default Swaps in the Wake of the Subprime Crisis* 19 (2009) (unpublished working paper for Int'l Monetary Fund Seminar on Current Dev. in Monetary and Fin. Law) (on file with author).

29. 12 U.S.C. § 290 (2006). See generally Jeffrey Rogers Hummel, *Federal Reserve Accounting and Its Solvency*, HISTORY NEWS NETWORK (Mar. 10, 2011), <http://www.hnn.us/blogs/entries/137460.html> (discussing Fed changes to its accounting for remittances to Treasury).

30. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 22 (percentage derived by dividing current "deposits" of "Depository institutions" by "Total liabilities").

31. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 24 (percentage derived by dividing current "deposits" of "Depository institutions" by "Total liabilities").

32. See, e.g., Peter Stella, *The Federal Reserve System Balance Sheet: What Happened and Why It Matters* (Int'l Monetary Fund Working Paper WP/09/120, 2009), available at <http://www.imf.org/external/pubs/ft/wp/2009/wp09120.pdf> (arguing that assets acquired due to financial rescue interventions are "policy" assets as distinguished from the ordinary monetary ones acquired during routine central bank operations).



free-standing resolution vehicle, like the Resolution Trust Corporation used after the savings and loan crisis.<sup>33</sup>

In Minsky's analysis, the Fed validated the speculative and Ponzi investment decisions of banks by buying their assets closer to par than to their then-impaired market value.<sup>34</sup> This probably made the Fed the last bank in the cycle to do a speculative Ponzi trade, albeit for the public interest. Although these credit terms are unsustainable for private firms, a central bank can depart more freely from hedged borrowing and lending because it has a monopoly on the production of legal tender and, hence, faces no short-term pressure to be profitable in a real sense. And because the Fed can hold debt to maturity more freely than private banks, it has time to ride out the troughs of economic cycles.

Overall, the financial sector has been substantially mended through this Fed initiative, other efforts to recapitalize the banking system by shoring up assets, and troubled asset relief program ("TARP") support for the liability side of bank balance sheets. What has not worked as well is the spreading of this recovered stability onto consumers and other firms, as banks remain cautious about lending. This bottleneck of liquidity in the financial sector may reflect that chastened banks have yet to reenter the early stage of the cycle, in which more hedged borrowing and lending takes place. More research is needed to understand the links between the financial sector and the real economy—the topic of the Levy Economics Institute's 2011 Minsky Conference.<sup>35</sup>

### *B. Contesting Market Primacy in the Age of Ideology*

Minsky's financial instability hypothesis addressed how individual firms borrow and invest and how these behaviors—in the aggregate—lead to sectoral tendencies.<sup>36</sup> As noted above, this was so because, left to their own devices, financial markets tended to overheat, leading the public sector to intervene as needed against the confidence (panic) cycle. At the same time, the public sector could precipitate instability by removing regulatory restraints on speculative and Ponzi financial activity. Implicated in this are political economy questions about whether real markets work as theorized, how much state influence over economic life is justified,

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33. On the Resolution Trust Corporation, see generally Lee Davison, *The Resolution Trust Corporation and Congress, 1989–1993* (pts. 1 & 2), 18 FDIC BANKING REV., no. 2, 2006 at 38, no. 3, 2006 at 1.

34. See MINSKY, *supra* note 9, at 206–08.

35. Press Release, Levy Economics Institute, Leading Economists and Policymakers to Discuss Ongoing Impact of the Global Financial Crisis at the Levy Economics Institute's 20th Annual Hyman P. Minsky Conference (Apr. 11, 2011), available at [http://www.levyinstitute.org/pubs/4\\_11\\_11.pdf](http://www.levyinstitute.org/pubs/4_11_11.pdf).

36. See generally Hyman P. Minsky, *The Financial Instability Hypothesis* (Levy Economics Inst. Working Paper No. 74, 1992), available at <http://www.levyinstitute.org/pubs/wp74.pdf>.

whether individuals are rugged enough to go it alone or whether unavoidable human vulnerabilities call for systematic state action, and who should pay for non-private costs of bailouts.

So around the core of the financial instability thesis, we can imagine criticism of ideologies that promote financial instability by hamstringing the public sector's efforts to counter the cycle. For example, some economic orthodoxies may deny that financial crises recur, insisting on inaction because, like the common cold, these cycles will work themselves out in time.<sup>37</sup> Moreover, ideological orthodoxy in economic matters from anywhere on the spectrum can exacerbate crises by not being flexible when what is needed is pragmatism. For example, the Community Reinvestment Act<sup>38</sup>—pushed by Democrats and progressives—encouraged commercial banks to originate subprime mortgage loans.<sup>39</sup> Because of their foreseeable exposure to interest rate risk from refinancing, when underwritten, many of these loans would almost certainly have been classified as speculative or Ponzi assets. The subprime market grew in tandem with deregulation of financial markets,<sup>40</sup> a view promoted from across the aisle but which, converging on federal efforts to promote homeownership, intensified the trends toward financial instability.

While ideologies that promote financial stability can come from either side of the aisle, the Right has largely captured the terrain of finance. Since the 1980s, the United States has witnessed a flowering of anarcho-capitalist, libertarian, neoconservative, and reactionary social formations that, despite other differences, unite against financial regulation.<sup>41</sup> We have yet to appreciate how these networking successes have rezoned our political imagination Rightward, even that of liberals and supporters of financial regulation. Because Minsky died as these formations were quickening, he did not get much of a chance to contest them using the financial instability thesis. For example, many who would shudder at the label “Keynesian” have referred to a “Minsky moment” without

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37. See, e.g., Gabilondo, *supra* note 10, at 247–54 (giving examples of objection to financial cycle theory).

38. Community Reinvestment Act of 1977, 12 U.S.C. §§ 2901–2908 (2006).

39. See Markham, *supra* note 28, at 4–7 (noting that large banking organizations seeking approval for mergers from the Federal Reserve pledged to allocate credit to borrowers who may not have otherwise met credit underwriting standards).

40. Philip Ashton, *Troubled Assets: Financial Emergencies and Racialized Risk 7* (May 2009) (unpublished working paper for Great Cities Inst.), available at [http://www.uic.edu/cuppa/gci/workingpapers/Ashton\\_Phil\\_5.09.pdf](http://www.uic.edu/cuppa/gci/workingpapers/Ashton_Phil_5.09.pdf).

41. These political alliances against regulation flow out of the generic mobilization of the new Right that began in 1968 with Richard Nixon and reached its apotheosis through the “emerging Republican majority” theorized by Kevin Phillips. José Gabilondo, *When God Hates: How Liberal Guilt Lets The New Right Get Away With Murder*, 44 WAKE FOREST L. REV. 617, 618–21 (2009).

owning the wider context for the financial instability thesis. It is ironic because Minsky sought to give a fuller account of John Maynard Keynes' radicalism, which he thought had been excised by the economics establishment of Keynes' day when it accepted his work. Minsky wanted to integrate the excluded elements.<sup>42</sup>

This latent dimension of Minsky's work deserves extending because its technical credibility could counter some of the ideological posturing advanced in the name of capitalism. In fact, there is more than one conception of capitalism, and his views might help elaborate alternative forms. This point matters because, despite the debt overhang from the last crisis, neoliberal hostility toward financial regulation is back in arguments based on *market primacy*.<sup>43</sup> This is the view that the uncoordinated, self-propelled actions of unregulated private actors will lead to better outcomes for them and for society than would state coordination.<sup>44</sup>

Markets are said to be better than the state for utilitarian and categorical reasons. First, the market is alleged to produce more than the state would with the same resources.<sup>45</sup> And the market is

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42. See generally Éric Tymiogne, *Minsky and Economic Policy: "Keynesianism" All Over Again?* (Levy Economics Institute Working Paper No. 547, 2008), available at [http://www.levyinstitute.org/pubs/wp\\_547.pdf](http://www.levyinstitute.org/pubs/wp_547.pdf) (contrasting Minsky's Keynesianism with mainstream Keynesianism).

43. See, e.g., Todd Zywicki, *Dodd-Frank and the Return of the Loan Shark*, WALL ST. J., Jan. 4, 2011, at A17 ("Congress can pass all the laws it wants, but it can't repeal the law of supply and demand and the law of unintended consequences.").

44. Ironically, given its role in promoting neoliberal values, it was a paper on government securities by the International Monetary Fund that made me see the inevitable role of the state in influencing market structure. See Peter Dattels, *The Microstructure of Government Securities Markets* (Int'l Monetary Fund Working Paper WP/95/117, 1995). The paper analyzes the choices that governments have when setting up markets for their own public debt markets, e.g., auction pricing, specialist versus market-makers. That there are choices to be made by public officials negates any "naturalness" of market structure. A second example came while at the U.S. Securities and Exchange Commission on an inspection of the specialist system at the New York Stock Exchange. This arrangement gives a monopoly on all the order flow for a security to one trader (the specialist) in exchange for his duty to make a fair and orderly market. The specialist does this by crossing the buy or sell orders of customers or, as needed, by using his own capital to effect a trade. An aesthetic of price is at work that favors incremental changes—in either direction—to swings. Issuers of the specialist's securities could complain when—in their profoundly interested opinion—the specialist had not "made markets" appropriately by creating a bumpy price path. An investigation and market reconstruction would follow. Here again were policy decisions at work rather than the canonical idea of forces of supply and demand meeting at a clearing price—so wide-eyed claims that markets are "free" suggest, to me, that the speaker is either profoundly naïve or disingenuous.

45. See, e.g., F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945) (emphasizing the importance of disbursed, localized knowledge in the economy).

better than the state on moral grounds because it stands in for pure freedom.<sup>46</sup> Adding the modifier “free” to “market” intensifies this devotional quality, sacralizing the market.

In theoretical accounts of the financial system based—explicitly or not—on market primacy, liabilities are no big deal. In a market, it is assumed price mechanisms will adjust by themselves to reflect the risks and effects of these liabilities. If a firm fails, creditors will devour it. This is the take on liabilities in Merton Miller’s acceptance speech for the Nobel Prize, which he received for the capital irrelevancy thesis. He said there was no such thing as an “overleveraged” firm because market price mechanisms would adjust its cost of debt and equity capital to reflect its risk.<sup>47</sup> Lenders would evaluate risk, bargain for an appropriate rate of return, demand collateral as needed, and, if necessary, sue for breach. There is no systemic risk here because all risk stays private.

True enough, if one stays inside of an abstraction that, necessarily, assumes away actual liabilities, real financial risks, and losses in the real world. So, in the market primacy narrative, there was no “problem” with the 2007 crash. It was a routine repricing of credit by forces of supply and demand, though the growth of the Fed is not ideal.

### C. *Enter Reality Stage Right*

However, market primacy faces some challenges. First, financial crashes always spill over into the public sector. In the now familiar script, an adventurous financial sector borrows itself into a crisis that threatens innocent bystanders, drawing in even advocates of market primacy. The Federal Reserve Act of 1913 grew out of the 1907 Knickerbocker Trust Company crisis;<sup>48</sup> the New Deal’s financial architecture responded to speculative overinvestment, intensified by easy margin credit;<sup>49</sup> and the 1989 Financial Institutions Reform, Recovery, and Enforcement Act responded to the savings and loan crisis of the 1980s.<sup>50</sup> The Act is merely the last iteration of this political economy cycle. So models that turn a blind eye to obvious, foreseeable public impact should be taken with a grain of salt.

Second, it was supply and demand—the self-adjusting

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46. See, e.g., ROBERT NORZICK, *ANARCHY, STATE, AND UTOPIA* (1974).

47. Merton H. Miller, *Leverage*, Nobel Prize Lecture (Dec. 7, 1990), in 1990 *Econ. Sci.* 291, 298–300, available at [http://nobelprize.org/nobel\\_prizes/economics/laureates/1990/miller-lecture.pdf](http://nobelprize.org/nobel_prizes/economics/laureates/1990/miller-lecture.pdf) (arguing that unregulated market forces can regulate the pricing of liabilities through interest rates).

48. See Steven A. Bank, *Origins of a Flat Tax*, 73 *DENV. U. L. REV.* 329, 379–80 (1996).

49. See A.C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices*, 95 *VA. L. REV.* 841, 847–57 (2009).

50. Tim Curry & Lynn Shibut, *The Cost of Savings and the Loan Crisis: Truth and Consequences*, 13 *FDIC BANKING REV.* no. 2, 2000 at 26.

hydraulics of market primacy—that contributed to the financial crisis. After all, it was devotees of deregulation—George W. Bush in the White House and Alan Greenspan at the Fed—who let subprime debt mushroom thanks to easy money and, it would come to light later, systematic mortgage fraud.<sup>51</sup> The risk to the financial system originated not in the state but—to further refute market primacy—from innovation in an overheated private sector whose private-label MBS came to displace the other MBS issued by government-sponsored agencies like Fannie Mae and Freddie Mac.<sup>52</sup>

The government's error was to validate this innovation by investing in some of these private-label securities.<sup>53</sup> Lenders in markets were wrong. And the quantitative financial models were wrong too because they did not predict how markets act in a panic, so called "extreme liquidity events." It is only the latest example of mistaking unsustainable practices for benign financial innovation.<sup>54</sup>

Were the marketplace of ideas and reputation to work as its libertarian custodians claim, we could have shorted market primacy and captured the spread as brand names like Alan Greenspan, Friedrich Hayek, and Milton Friedman went down in a bear raid. Instead, the spirit of deregulation has survived a financial crisis that it had a hand in creating. It is not as odd as it sounds because, like limited liability for corporations, market primacy is a potent distillation of exclusions, erasures, and omissions of facts that might compromise its theoretical integrity. It saves face by ignoring corporate insolvencies, credit scarcity, unemployment, foreclosures, losses in retirement funds, growth in the federal deficit, incipient inflation of energy and food, and sagging real estate values—in other words, other people's problems. Indeed, it is these efficiencies

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51. See, e.g., S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG., *WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE* 95–103 (2011).

52. An industry journal of the time noted the development with glee: Now, issuers of private-label residential MBS are holding the aces that were once held by the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. Once a junior—but powerful—player in the market, private-label residential mortgage backed securities (RMBS) are now the leading force driving product innovation and the net overall volume of mortgage origination.

Robert Stowe England, *The Rise of Private Label*, MORTGAGE BANKING, Oct. 2006, at 70, 70.

53. Theresa R. DiVenti, *Fannie Mae and Freddie Mac: Past, Present, and Future*, 11 CITYSCAPE 231, 237 (2009) ("The private-label securities contributed significantly to the GSEs' losses in 2008; in many cases, the value of the securities fell as much as 90 percent from the time of purchase.").

54. Legal scholarship, in particular, has a duty to evaluate these practices carefully, although it has not done so enough. See Charles R. P. Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternatives*, 51 SMU L. REV. 505, 508 (1998) ("Legal scholarship has not produced critical examinations of financial innovation as an economic process. . . . The products generated [by financial innovation] are readily accepted and adjudged good.").

of externalization that have allowed corporate profits to rebound despite other weaknesses in the economy.<sup>55</sup>

An example of market primacy about the Act is the street's hue and cry against the Act's mandate that regulators bear down more on the swap markets. Swaps are financial bets about future price movements that banks and other large firms place with each other, acting as "counterparties." The Act requires the Commodity Futures Trading Commission and the banking agencies to establish margin requirements and collateral policies to reduce the risk of default on these bets.<sup>56</sup> Doing so, it is thought, will reduce the risk not only to the counterparties but to the financial system as a whole.<sup>57</sup>

However, the prospect of regulation has been met with objections by many firms, including nonfinancial ones that use swaps for hedging rather for speculative investment.<sup>58</sup> In part it is because swaps are the poster child of imaginaries of the market. Since Wendy Gramm, then head of the Commodity Futures Trading Commission, secured a major exemption from their regulation in 1993,<sup>59</sup> swaps have been sacralized as financial play in the libertarian forest primeval, away from the grasping hands of the state. The resistance from firms seems to have worked given the broad exemptions that have been given to noncommercial end-users of swaps.<sup>60</sup>

Once put in focus, market primacy shows up as an attack on the very notion that there could be such a thing as a public interest and, insofar as it is recognized to exist, justifying it only insofar as a public function serves private interests. This is what lies behind challenges to how the state provides services that have been the hallmark of the public sector.

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55. See Luca Di Leo & Jeff Bater, *New Jobless Claims Cloud Economic Outlook*, WALL ST. J., May 27, 2011, at A3 (reporting increasing corporate profits).

56. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 701–754, 124 Stat. 1376, 1641–1754 (2010) (to be codified in scattered sections of 7, 11, 12, and 15 U.S.C.).

57. See generally Michael Greenburger, *Overwhelming a Financial Regulatory Black Hole with Legislative Sunlight: Dodd-Frank's Attack on Systemic Economic Destabilization Caused by an Unregulated Multi-Trillion Dollar Derivatives*, 6 J. BUS. & TECH. L. 127 (2011).

58. Victoria McGrane, *Risk Rule Riles Main Street: U.S. Wants Car Makers, Brewers to Back Derivatives Bets with Cash; Cost at Issue*, WALL ST. J., Apr. 13, 2011, at A1 (summarizing objections by nonfinancial users of swaps to CFTC's margin and collateral proposals).

59. See Carolyn H. Jackson, *Have You Hedged Today? The Inevitable Advent of Consumer Derivatives*, 67 FORDHAM L. REV. 3205, 3221–22 (1999).

60. Cheyenne Hopkins & Joe Adler, *Regulators Give Banks Win on Key Derivatives Proposal*, AM. BANKER, Apr. 13, 2011, at 1 (noting that pressure from Congress resulted in ongoing exemptions from margin and collateral rules for corporate end-users).

Consider the new reach of market logic into higher education and state government. A narrow cost logic is at work in legal education through the American Bar Association's recent proposals on security of position, reforms that would reduce the agency costs of having faculty.<sup>61</sup> A similar cost logic is at play in reform proposals about state government. The proposals to allow states to declare bankruptcy would allow them to cleanse their balance sheets of liabilities for the pensions of public employees.<sup>62</sup> Like the perennial anti-hero of the Nightmare on Elm Street, Freddie Krueger is back, this time in the citadels of the public.

The attack is old news. What is new and worth attention is how the discursive formations of reactionary thought are maturing. By "discursive formation" I mean the way that institutions, individuals, and political narratives move in tandem to form a new consensus of reality, one that amplifies neoconservative values by erasing those of others. At the institutional level, this is evidenced by the rise of foundations and advocacy groups whose influence reaches deep into private enterprise, the federal courts, and state government.<sup>63</sup> These activist networks produce and market—and are in turn legitimated by—narratives, symbols, and social scripts that create a conceptual framework for understanding reality through a reactionary lens. On economic matters, Minsky's theory can help to contest these discursive formations of the Right.

## II. INTERNALIZING LIABILITIES THROUGH THE DODD-FRANK ACT

If we believe, as did Minsky, that capitalist market systems could be enhanced by mitigating leverage cycles, then we judge the Act by whether it does so. Because it was passed during a window of financial ruin that temporarily muffled some libertarian activists, the Act does take some steps to limit financial instability caused by liability financing. While market primacy shifts some of the costs of overleveraging onto strangers, the Act tries to do the opposite, allocating more of the total effect of liabilities onto those who generate the debt. Below I discuss two examples of this internalization: risk management rules for leverage created by financial swaps and regulatory capital requirements that slow down, rather than intensify, boom-bust cycles.

### A. *Limiting Swap-Induced Leverage*

As explained here, many financial swaps include contingent

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61. Mark Hansen, *Too Much Momentum?*, A.B.A. J., May 2011, at 55.

62. See Lisa Lambert, *State Bankruptcy Bill Imminent, Gingrich Says*, REUTERS, Jan. 21, 2011, available at <http://www.reuters.com/article/2011/01/21/us-usa-states-bankruptcy-idUSTRE70K6PI20110121>.

63. See generally Lester M. Salamon, *The Resilient Sector: The State of Nonprofit America*, in THE STATE OF NONPROFIT AMERICA 3 (2002).

leverage that springs into effect when the market moves against a bank. These sudden market moves can turn a swap from an asset to a liability or from a small liability to a giant one. An example illustrates the problem. Assume that Party A and Party B enter into an interest-rate swap. If the market moves against Party A, the swap becomes an out-of-the-money position, with Party A owing money to Party B as a net swap payable.<sup>64</sup> To Party B, the swap is an asset because it is in-the-money and, hence, a net swap receivable.

As this example shows, a swap can fluctuate between being an asset or a liability based on market movements and contingencies that are built into the swap. (Such was the case at AIG when swap commitments made by its financial products unit became liabilities rather than assets.) These market contingencies are the heart of the bargain that is entered into every time someone enters into a swap position. Moreover, because many swap counterparties waive margin for an entity with a good credit rating, swaps can produce uncollateralized debt that can suddenly increase a firm's effective leverage.

The moral of the story is that the unintended—though foreseeable—liabilities that can arise through swap contracts also need provisioning and risk management. The Act reduces the growth of speculative and Ponzi liabilities that might arise from swaps activities—especially by financial firms—by requiring that standardized swaps be settled through a clearinghouse that would impose margin requirements to eliminate the risk that a liability would lack adequate collateral.<sup>65</sup>

Once swaps clear on a central counter party, each member will have to post initial margin, post variation margin based on market changes, and make a contribution to the guarantee/clearing fund as it begins to accumulate a liability with respect to a swap position. Centralized clearing of swaps and margining generally may also reduce the funding liquidity of some firms. Not all swaps will have to be cleared centrally. To create a kind of parity, the Act also imposes margin and collateral rules on swaps that remain on the

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64. This is what out-of-the-money credit swaps did to AIG. See Mary Williams Walsh, *Risky Trading Wasn't Just on the Fringe at A.I.G.*, N.Y. TIMES, Jan. 31, 2010, at B1.

65. For those swaps that are cleared bilaterally rather than being moved to a central clearing house, an additional regulatory capital charge may apply on the theory that this nonstandard position imposes more systemic risk than a position that has been moved to a CCP. See Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564 (proposed May 11, 2011) (to be codified at 12 C.F.R. pts. 45, 237, 324, 624, 1221); Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27802 (proposed May 12, 2011) (to be codified at 17 C.F.R. pts. 1, 23, 140); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (proposed Apr. 28, 2011) (to be codified at 17 C.F.R. pt 23).



books of the original counterparties.<sup>66</sup> The margin rules for uncleared swaps may also reduce the funding liquidity of swap counterparties who post margin.

From the perspective of the financial instability hypothesis, do the new clearing and margin rules for swaps increase or decrease financial fragility? To apply Minsky's debt classification to the new swap rules, first convert the margin or collateral into an income stream that backs the interest payments and amortization of principal on the debt.<sup>67</sup> The analysis is different for cleared and uncleared swaps.

The margin requirements keep the individual clearing members from accumulating uncollateralized liabilities to the clearing house. This limits the risk that swaps will add speculative and Ponzi exposure to the liability structure of a clearing member. The swaps clearing house will be subject to strict risk management rules that limit its overall risk.<sup>68</sup> Assuming, then, that it behaves like clearing houses for other asset classes, the swaps clearing house will not generate speculative or Ponzi risk.

The implications of margin on an uncleared swap, that is, one that stays on the books of the counterparties, follow below using the example from above. As suggested, Party A is short on the swap and would have to post margin to cover his liability to Party B. By collateralizing this debt, Party A's liability structure moves toward hedged borrowing from speculative and Ponzi positions. Posting margin may reduce Party A's borrowing cost because Party B should accept a lower interest rate on collateralized debt. If Party A posts cash collateral, however, its balance sheet also becomes less liquid and it is left with less unpledged collateral. Less potential collateral limits Party A's ability to invest in the other firms (including in the liabilities) and its own ability to borrow on a collateralized basis.

The leverage and liquidity implications are the converse to Party B, who receives margin from Party A. By reducing counterparty credit risk to Party A, the margin shifts Party B's asset structure toward hedged from a potentially more speculative or Ponzi position. If Party B can re-hypothecate the margin collateral, he has two more options. First, he can collateralize his own debts, making his own liability structure more hedged. Second, he could do the opposite by using the collateral to borrow more and use the proceeds to acquire a new asset, whose value would reflect the leveraged demand made possible by borrowing.

Given that margin can directly affect a firm's access to liquid

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66. Pub. L. No. 111-203, § 731, 124 Stat. 1376, 1703–12 (2010).

67. Though not explicit, Minsky's classification appears to assume uncollateralized borrowing. The following discussion applies the leveraged liquidity framework developed in my article on leveraged loans. Gabilondo, *supra* note 10, at 474–76.

68. Pub. L. No. 111-203, § 725(D), 124 Stat. 1376, 1688–89 (2010).

resources and its ability to leverage itself, the new margin rules—both for cleared and uncleared swaps—give regulators another tool that can be used counter-cyclically against the confidence (crisis) cycle. A tight collateral policy during good times would slow down growth, but a loose collateral policy on the downside of a credit bubble would take pressure off firms.<sup>69</sup>

The effects are more variable in the case above of an uncleared swap, because margin redistributes risk, liquidity, and leverage between the payor and payee. Because neither the market nor regulation require all liabilities to be margined, the ultimate effect of imposing margin on leverage created by uncleared swaps will depend on the opportunity costs to the payor of posting margin and the reinvestment opportunities to the payee.

Two other provisions of the Act that further limit the risk of sudden leverage from financial swaps by limiting the amount of swaps activity that certain financial institutions engage in are the Volcker Rule<sup>70</sup> and the swaps pushout rule.<sup>71</sup> Both require divestiture by many banks of certain derivatives activity. The Volcker Rule limits the amount of swaps activity that a bank can conduct. Separately, the swaps pushout rule limits the ability of banks to enter into swap agreements for their own account, although some important exceptions remain, including entering into swaps positions to accommodate customer interest. Together, these provisions may cleanse much springing and contingent leverage out of the bank.

### B. *Countercyclical Capital Requirements*

The Act also nods to Minsky by calling for capital requirements that go against rather than with the prevailing direction of the business cycle.<sup>72</sup>

Federal law requires a bank's capital structure to meet certain prudential standards for its balance sheet.<sup>73</sup> Potential investors

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69. This is what the Fed did by expanding the kinds of acceptable collateral that banks could use for discount window borrowing. See Steve Goldstein, *Fed Expands Auction, Accepts Wider Collateral*, MARKETWATCH (May 2, 2008), <http://www.marketwatch.com/story/fed-expands-auction-accepts-wider-collateral-to-boost-liquidity-200852105100>.

70. See Megan Davies & Svea Herbst-Bayliss, *Volcker Impact Sends Shivers Through Banks*, REUTERS, Aug. 9, 2010, available at <http://www.reuters.com/article/2010/08/09/uk-volcker-idUSLNE67800N20100809>.

71. Annette L. Nazareth, *Dodd-Frank Act Finalizes Swap Pushout Rule*, HARV. L.F. ON CORP. GOVERNANCE & FIN. REG., (July 7, 2010, 9:13 AM), <http://blogs.law.harvard.edu/corpgov/2010/07/07/dodd-frank-act-finalizes-swap-pushout-rule>.

72. Michael Kowalik, *Countercyclical Capital Regulation*, FED. RES. KAN. CITY ECON. REV., 2d Quarter 2011, at 63, 63–64, available at <http://www.kansascityfed.org/publicat/econrev/pdf/11q2Kowalik.pdf>.

73. For an example, see 12 C.F.R. § 3 (2011) for the regulatory capital rules

may apply more stringent standards, but federal law establishes the minimum. These standards promote solvency by measuring the bank's assets conservatively and ensuring that the bank has enough equity capital free from the contractual constraints that creditors impose on debt financing. The standards do this by subjecting the bank's balance sheet to various solvency and liquidity tests, each of which must be satisfied for the bank to remain in the best standing with its federal regulator.

For example, the tests promote conservative valuation when determining the bank's net worth (reflected in its equity capital) by aggressively discounting assets to reflect what they might fetch in a distressed market.<sup>74</sup> These asset discounts reduce the bank's net worth on a dollar-for-dollar basis, a loss that is born first and wholly by the bank's equity. So a bank's net worth calculated for its regulatory capital requirements will often be lower than its net worth based on generally accepted accounting principles. This is how the conservative valuation is accomplished. The federal government wants to have this conservative measure because the federal promise to insure certain bank deposits leaves the government on the hook as a back-up source of downside risk capital if the bank fails.

To complement this conservatism, other tests apply to the right-hand side of the bank's balance sheet. These rules are conservative because they limit how much the bank can leverage itself with borrowed money, including federally-insured deposits. The limit is expressed as a multiple of the equity that determines the maximum amount of debt that the bank can take on.<sup>75</sup> Capping debt leverage increases the bank's financing costs because the interest costs of debt are deductible, while equity investors demand a higher rate of return for investing as owners. Hence, a bank—like any firm—tends to pay more for equity capital than for debt capital. Although there is no limit to how much owners can make from a successful company, lenders can, at best, expect to receive only their contractual entitlement. As a result, lenders have more contractual rights to protect their expectancy in the firm than do its owners. Enough equity reassures regulators that the bank has an adequate resource cushion free from the contractual rights that, if breached, give the creditor rights to interfere in how the bank is run. One

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that apply to national banks.

74. See Kowalik, *supra* note 72, at 66.

75. For example, banks are generally required to hold 4% of their financial capital, i.e., debt and equity capital, in relatively permanent forms of risk capital designed to bear residual loss known as Tier 1 capital, e.g., common stock and noncumulative preferred stock. *Id.* at 80 n.6. Disregarding for the moment other capital ratio rules that apply, that requirement would limit the bank's potential debt to equity ratio to 25:1. In practice, it is lower because of concurrent requirements that apply to less residual forms of financing like subordinated debt.

effect of ensuring a minimum amount of owner's capital is to limit the overall size of the bank's liability base with respect to which the bank owes contractual duties that limit its freedom of action.

At present, these regulatory capital requirements have the unintended effect of amplifying the credit cycle.<sup>76</sup> When interest rates are low and the bank can easily make loans, its assets increase, marking up the bank's net worth and making it easier for the bank to borrow more, replenishing its ability to repeat the asset growth-equity-growth-borrowing growth cycle. More credit means more dollars chasing the same assets, which means that prices go up in the aggregate. The discounts used to haircut assets do not take into account the risk that assets are rising because a credit bubble may be underway, based on unsustainable escalation of market values. As a result, the intended conservatism of regulatory capital is somewhat offset by inflated asset, equity, and debt values. So the capital tests do nothing to slow down this inflation and, instead, by continuing to signal that the bank is solvent and liquid, give a green light as the bubble inflates.

The opposite kind of amplification happens as the bubble deflates. This time, the market value of outstanding loan assets begins to drop, shrinking the bank's balance sheet as the market applies a haircut of its own. Regulatory capital makes matters worse by adding another asset haircut, one that may be less justified because the market is already discounting. Every time an asset loses a dollar of value, the bank's net worth (its equity capital) drops by a dollar. As the equity base shrinks this way, the bank loses its ability to keep borrowing because of the leverage limits keyed to the bank's equity. To avoid losing regulatory status by becoming over-leveraged, the bank will begin contracting. If this means cutting its leverage, then the bank may have to dispose of assets to pay a liability.

Unfortunately, the asset may fetch less than par in a hasty sale, so the bank may face a nasty cycle of deleveraging leading to fire sale prices, leading to more deleveraging.<sup>77</sup> Moreover, during this cycle credit is harder to get because the bank is pickier about investing in loan assets, the more attractive ones being those not subject to a regulatory asset haircut because they boost the bank's net worth most directly. Less credit means fewer dollars chasing the same assets, which drives prices down. So, on the downside of the cycle, regulatory capital rules discourage lending just when the

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76. See generally James B. Thomas & Joseph Haubrich, *Keeping Banks Strong: Countercyclical Capital Requirements*, *FOREFRONT*, Winter 2011, at 16, available at [http://www.clevelandfed.org/forefront/2011/winter/pdf/ff\\_2011\\_winter\\_07.pdf](http://www.clevelandfed.org/forefront/2011/winter/pdf/ff_2011_winter_07.pdf).

77. See, e.g., Adrian Blundell-Wignall, *The Subprime Crisis: Size, Deleveraging and Some Policy Options*, 2008 *FIN. MARKET TRENDS* 29 (examining deleveraging of subprime mortgages).

market could use a boost from more credit.

One way to mitigate the tendency of regulatory capital to amplify the direction of the boom-bust cycle in asset prices would be by taking account of whether asset prices were rising or falling and, consequently, whether the market was overestimating or over-discounting an asset's ultimate value. On the upswing of the cycle as banks expand their balance sheets with new loans—adding inflationary momentum by financing more demand—banks should be subject to higher rates of required equity on the right-hand side of the balance sheet. Because equity capital is more expensive and generally harder to get, increasing the equity bite delays the bank's ability to keep growing with borrowed funds. This pause in financing on the upside is likely to slow down asset growth.

The opposite happens on the downswing. As the value of outstanding loan assets begins to drop, the regulatory discounts on the asset values should be relaxed, avoiding a direct dollar-for-dollar reduction in net worth for every loss in a loan asset. Preserving the bank's net worth this way keeps it from having to quickly deleverage by shedding impaired assets into an already illiquid market. This cannot stop the cycle, but it slows it down and tries to produce a softer landing.

This is what is meant by countercyclical requirements. Reducing the unintended and highly undesirable amplification of the boom-bust cycle caused by regulatory capital rules goes to the heart of Minsky's advice for reducing the growth of fragility and slowing down the contraction of debt-financed consumer demand. Banking regulators have recommended that regulatory capital eliminate this procyclicality by building in additional countercyclical capital requirements.<sup>78</sup> Many implementation issues remain but it is an important step in the right direction.

#### CONCLUSION

New financing arrangements will always require original analysis to determine how they affect the financial system as a whole. That analysis should draw on liquidity and leverage axioms derived from Minsky's framework about financial instability. Doing so would help to forecast an individual firm's financial future, especially if it must refinance. This kind of analysis also sheds light on how firm borrowing impacts the stability of the financial system as a whole. Now more than ever, perspectives like this matter because the ultimate impact of the Dodd-Frank Act still hangs in the balance. If implemented in good faith, the Act could enhance our capitalist system by mitigating financial cycles. Whether or not

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78. See Kowalik, *supra* note 72, at 66–69; see also BASEL COMM. ON BANKING SUPERVISION OF THE BANK FOR INT'L SETTLEMENTS, COUNTERCYCLICAL CAPITAL BUFFER PROPOSAL (July 2010), available at <http://www.bis.org/publ/bcb172.pdf>.

it will live up to this promise remains to be seen.