September 2009

Rebuilding Wall Street:
A Review of the White House Proposal for Reforming Financial Services Regulation

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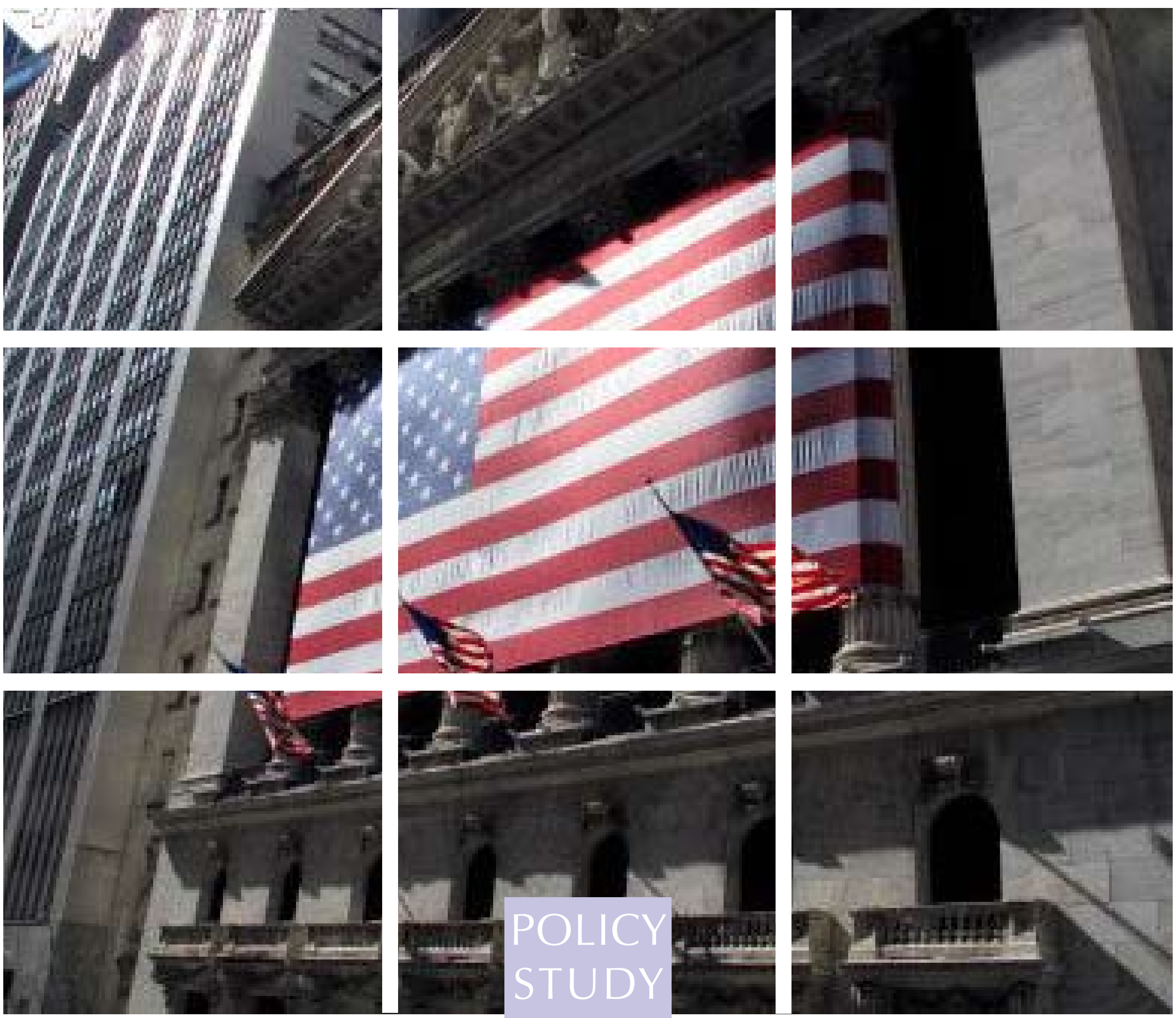

POLICY STUDY 377

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Part 1

Introduction

The role of regulation in the creation and evolution of the financial crisis has been one of the hottest debate topics in the midst of this recession. Undoubtedly, regulators played a part in creating the mess, though how and to what degree remains undecided. One thing that everyone agrees on is the need for change in the current financial sector regulatory structure. What isn't agreed upon is whether change should take the form of new regulations or the repeal of old, problematic rules. And the change camps disagree on what kind of laws should be added, or which ones should be repealed.

Financial sector regulators are charged with maintaining the stability of the system, partly by providing oversight to banks and other financial institutions. Consumer protection and the prevention of fraud is another main role of financial sector regulators. In light of the financial crisis, the regulatory regime has clearly failed in some respects, though there is significant debate about how they failed.

As a part of a broader effort to enhance America's financial stability, President Obama and his economic team have proposed a series of changes that dramatically overhaul financial services regulation. The 89-page proposal was sent to Congress on June 17, 2009 to guide the creation of a regulation overhaul bill. In remarks at the release of the proposal, President Obama said he believed the lack of system-wide regulations led the nation to near catastrophe and that the best course of action is to promote oversight processes for the financial sector as a whole. [1]

The president also established a clear guideline for developing changes in the financial services regulatory structure:

> *We don't want to stifle innovation. But I'm convinced that by setting out clear rules of the road and ensuring transparency and fair dealing, we will actually promote a more vibrant market. This principle is at the heart of the changes we're proposing.* [2]

This guiding principle is in line with the widely shared goals for financial sector regulation: to facilitate competition, to provide a common set of standards—the "rules of the road"—for market actors, to offer accountability and to enforce the law.

However, there is more to regulation than just creating regulatory road rules. To be helpful, those rules need to promote market discipline, provide incentives for good banking practices, prevent information asymmetry where a few people have significantly better information than the average investor, and discourage harmful business practices. The rules must not impede the wealth creation process or give certain firms special advantages. The wrong rules will stifle innovation and suffocate the market.

Getting regulation right is hard work, and even with their good intentions, regulators too often skew market activity and create perverse incentives for investment. Although many financial sector regulations are out of date and problematic in many ways, the restructuring process could cause even more damage if it is not done properly.

This paper will begin with a discussion of principles for regulating financial services. Developing a good framework for assessing regulatory change and examining the history of deregulation secures an established base for considering proposed solutions to today's problems. This paper then explains the Obama administration's proposals and some of the common critiques of the president's ideas. Finally, this paper analyzes what the proposed ideas mean for the future of the American economy and offers some suggestions for bringing about regulatory reform.

Part 2

The Principles of Financial Services Regulation

A. The Framework for Assessing Regulations

Vital to designing beneficial regulations is an understanding of how government rules can sometimes go wrong, causing more harm than good. Regulations always have the potential to result in a host of unintended consequences, create perverse incentives that distort decision-making, and hinder wealth creation.

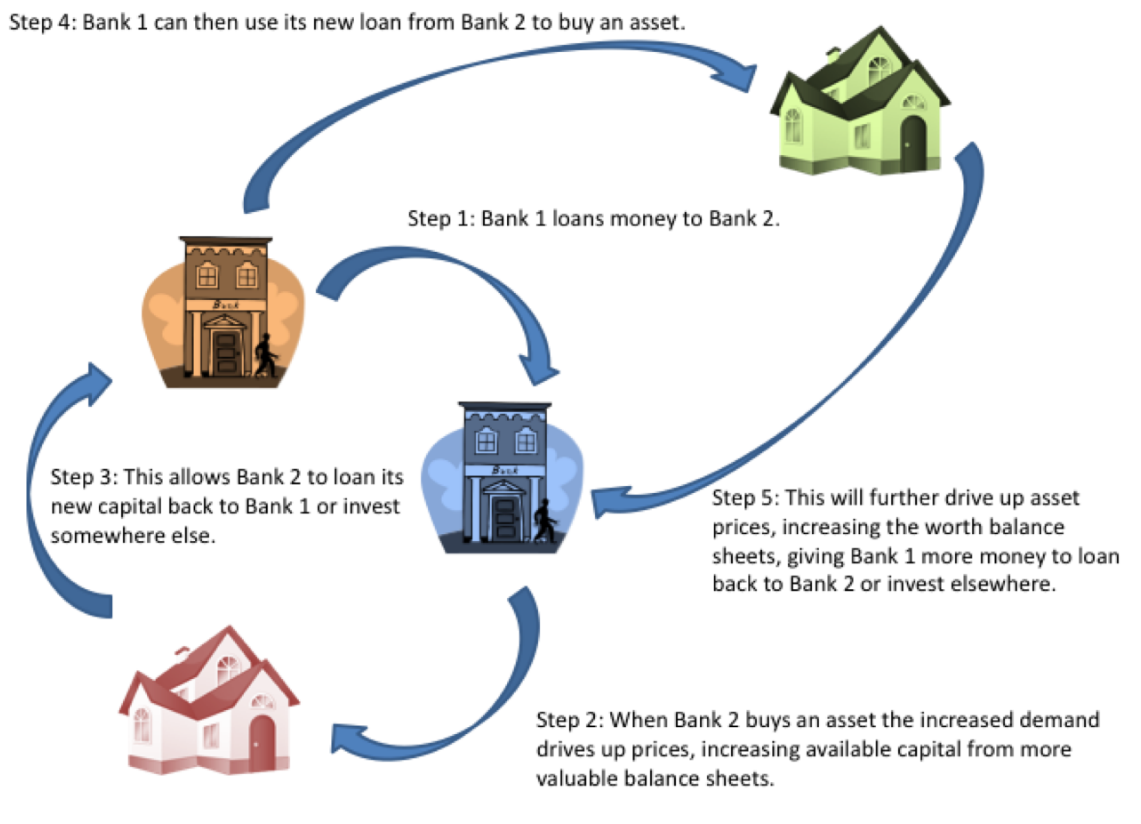
Perverse regulations often come from inflexible or outdated rules that were not made to adapt to changes in the way the market functions. (They also come from hasty, overreaction to an event in the marketplace; see the discussion of Sarbanes-Oxley in Section E.) Regulation writers must be aware that unintended consequences are likely to be the result of any rule that restricts competition or frees up financial institutions from bearing the responsibility for their own risks.

The mark-to-market accounting rules for valuing assets provide a perfect example of well-intended but harmful regulation left on the books too long without getting an upgrade. The laws were abused by firms seeking new capital during the bubble period, but they also rigidly priced assets below their long-term values during the meltdown last fall creating huge balance sheet problems for financial institutions.

Prior to the economic meltdown, mark-to-market (MTM) accounting rules required that financial institutions mark the value of their assets to the value of similar assets recently sold in the marketplace, regardless of an institution's optimism that the asset's price would rise in the future. These laws were intended to create an impartial accounting method for determining the value of financial assets, and establish a standard to prevent firms from fraudulently pricing their assets. The accounting rules provided regulators, such as the FDIC, with up-to-date statements on an institution's net worth, thereby providing a timely signal for when an organization is trending toward insolvency.

As housing prices began to rise in 2002, they carried the rest of the market up with them, including asset prices in general. As firms bought and sold assets, the increased demand caused asset prices to grow exponentially. Under MTM rules, this increased the value of assets on all financial institution balance sheets. This allowed banks to use more of their capital for investments with high-priced assets anchoring their balance sheets and fulfilling capital requirement rules. Financial institutions realized that if they borrowed more money to buy assets, the increased demand would increase the value of all similar assets—including the similar assets they already owned. This in turn freed up more capital to lend and invest. The bigger the housing bubble got, the higher the demand for assets rose, and the nastier the cycle became.

Figure 1



Serious problems began when asset values destabilized in September 2008. The collapse of Fannie Mae and Freddie Mac triggered a temporarily loss of value for billions worth of assets, and MTM rules required assets to be priced dramatically below their estimated long-term worth. The cycle suddenly shifted downwards, and firms were left scrambling to acquire capital as the downward spiral of asset prices put their balance sheets in the red.

Critics have claimed that the pricing down to zero for many assets was simply the market setting the right price. But while the market price is always the real worth of an asset, the potential for it to regain value lost during an exceptional situation should be taken into consideration for accounting purposes. During periods of economic growth, indications of insolvency from mark-to-market accounting can be considered fairly accurate. However, an adjustment should be made when the entire market moves into a temporary downturn, particularly a liquidity crisis.

The rapid loss of asset values sent firms scrambling for cash to meet balance sheet requirements. This was not necessarily because the firms became insolvent but because the market became illiquid. The credit markets froze and access to capital dried up. In the heat of the moment, institutions such as Lehman Brothers and Washington Mutual weren't able to acquire enough operating money and were dissolved. While it is possible these firms would have become insolvent, the problems that caused their collapse were related to liquidity in the market and MTM accounting rules for the structure of their businesses.

Had the laws been more flexible, firms could have been given a six-month window to stabilize their balance sheets before marking down assets, given the extreme economic scenario. This would have given institutions time to sell assets, get operating capital, or file for an organized bankruptcy to avoid shocks to the market.[3] The flexibility takes into account the highs and lows of the market and avoids rigidity in an always changing industry. Eventually, the Financial Accounting Standards Board—the group that sets rules like mark-to-market—did change the regulating to be more flexible in this way, but by the time they passed the change in April 2009, most of the damage had been done.[4]

Another regulatory failure leading into the financial crisis was the perverse incentives created by the implicit guarantee of rescue for firms "too big to fail" or too interconnected in the financial system for risk-averse regulators to allow failure. Government and regulation can significantly influence how financial institutions manage their risks and liabilities. A bailout guarantee encourages firms to leverage high and take on large amounts of debt. Better regulation will force companies to suffer their own losses, encouraging prudent risk-taking instead of dependence on the taxpayer. It is important for regulators to analyze how market actors will respond to their rules and ensure that regulations will not create larger problems than they solve.

Both "too big to fail" and the mark-to-market rules were policies that had value on the surface but created significant unintended consequences. The way regulation writers approach the rules they create matters, particularly when it comes to fully analyzing what impact a rule might have on the way financial institutions operate and take on risk.

The Administration argues that many problems have been created by a system of oversight that is too complicated with regulation gaps. An overly complex regulatory structure makes it more difficult for business to operate, which destroys wealth. Treasury Secretary Timothy Geithner said in May 2009, "I personally believe we need to, and I think the president believes we need to have a much more simplified, consolidated oversight structure. Our system now is too complex." Regulations that exacerbate the complexity of the current bureaucracy would increase compliance costs and make it harder for institutions to know what rules to follow.

It is also important to understand how regulations levied on American firms affect their ability to compete in a global market. More unintended consequences could arise from misinterpreting how markets will respond to new regulations. John Jay, senior analyst at the business advisory service Aite Group, wrote in *BusinessWeek*, "The financial markets are global. As such, banking and financing business may very well migrate to regions with less stringent oversight. In seeking to safeguard the U.S. financial system, the Administration must take care not to put U.S. financial firms at a competitive disadvantage."[5]

B. Risk Management: Resilience vs. Anticipation

An important aspect of establishing a framework for assessing regulations is the role of risk management. There is a tension between designing regulations that anticipate risks and regulations that establish resilience during economic downturns. Anticipation is an unconstrained view that believes with perfect foresight, risks can be planned for and avoided. Resilience takes a flexible approach to risk management, preparing to take acceptable losses in a downturn.[6] When regulations are designed, they generally fall into one of these two categories. Understanding which category a regulation belongs to is important for assessing its impact and potential unintended consequences.

UC-Berkeley political scientist Aaron Wildavsky established this dichotomy in his 1988 book, *Searching for Safety*: "Anticipation seeks to preserve stability: the less fluctuation, the better. Resilience accommodates variability; one may not do so well in good times but learn to persist in the bad."[7] The dichotomy is between two perspectives of the goal for regulation: stability versus adaptability. In Wildavsky's view, anticipating risk is a prevention-focused mode of central control, while resilience is a capacity to cope with unknown dangers when they arise.[8] When it comes to financial services regulation, a healthy portion of both risk management perspectives is beneficial.

Anticipation	Resilience
▪ Unconstrained view of regulatory ability to stop problems with enough authority	▪ Constrained view of regulators' ability to foresee every possible economic storm
▪ Rigid laws that seek to prevent recessions from ever happening	▪ Flexible laws that are willing to accept and deal with recessions
▪ Seeks to preserve stability	▪ Seeks to maintain adaptability
▪ Designed to cope with all known economic dangers	▪ Designed to cope with unknown economic dangers
▪ Believes perfect knowledge can prevent all future disaster	▪ Does not believe perfect knowledge is possible
▪ Breaks down when the market experiences major changes	▪ Absorbs blows when the market makes major changes
▪ Involves deep, intellectual examination to discover all problems and solutions	▪ Involves analyzing all unknown factors that could skew regulation to unintended consequences
▪ Requires complete knowledge of past, current and future market activities and innovation	▪ Requires significant pain tolerance for inevitable recessions and downturns

Anticipating risks and designing rules to eliminate them are good strategies. However, when those regulations are so rigid that they contribute to a crisis, as the mark-to-market rules did, the value of resilience is made clear. Anticipation is positive because it encourages deep, intellectual consideration of the status of the market. But the knowledge of regulators is not perfect and will never be complete. Ultimately, anticipation can only go so far. It is impossible to know every risk and predict every danger. There is value in designing regulations that accept recessions and absorb the blows when they come.

Anticipation also requires that regulators themselves be consistent in the face of market fluctuation. *Time Magazine* economics analyst Justin Fox wrote: “Regulators aren't immune to the boom-bust cycle. They have an understandable habit of easing up when times are good and cracking down when they're not. In doing so, they often amplify the ups and downs of markets rather than modulate them.”[9] Regulations that try to anticipate risk can be helpful, but then cannot be depended on alone to prevent crisis.

Still, even though there is value in resilience regulation, it must be accompanied by a pain tolerance for when recessions come. This means understanding that short-term unemployment is a signal that labor resources are shifting to a more profitable use, but in the near term there will be some economic discomfort. Regulations that promote resilience in the market will accept that firms sometimes fail, and allowing resources to shift from a failed venture—even one established for a long period of time—is the market’s way of being efficient.

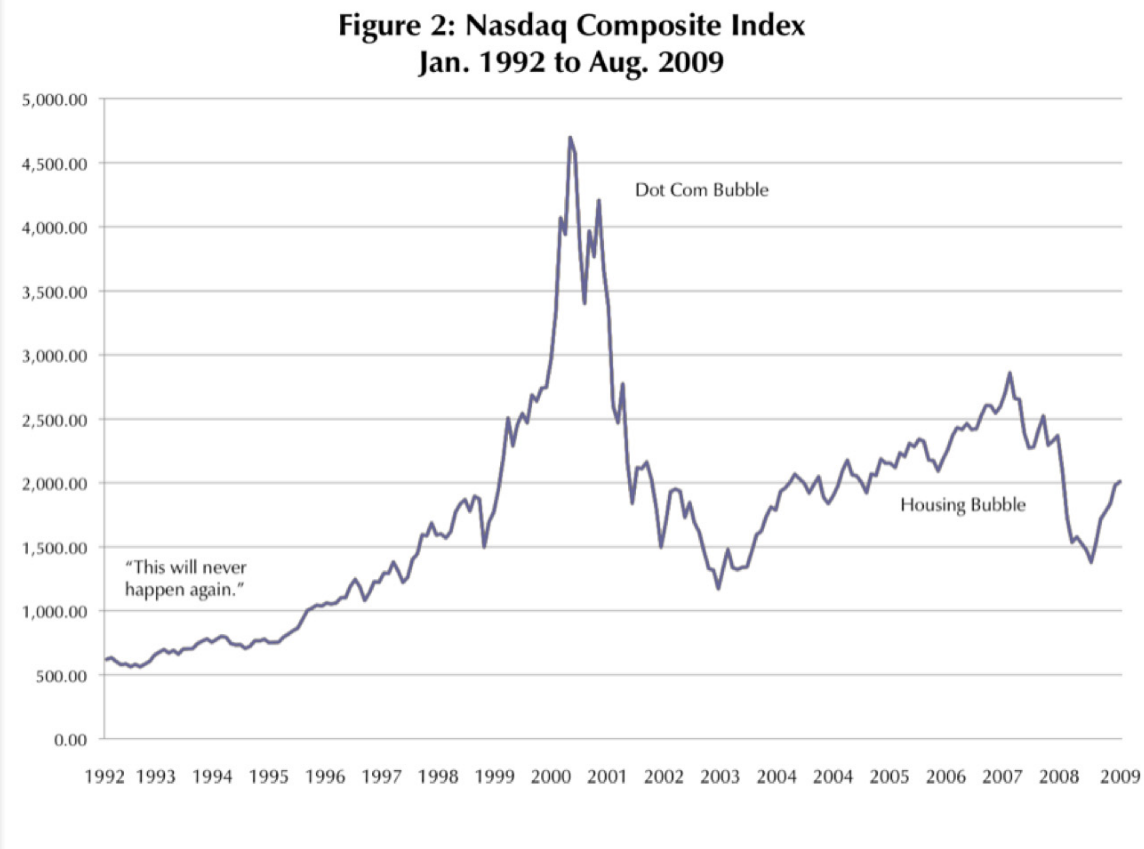
C. The Danger of Overconfidence and Overreaction

Anticipation regulation generally breaks down over the long term because it is static. Human tendency often leads us to believe that new laws can easily overcome problems of the past. There is also an American tendency to believe we are an indestructible nation, leading us to wait for crisis before changing regulations. Given this overconfident nature, when recessions like the current financial crisis cycle through the economy, they cause more shock and surprise than they should.

Despite a history of ups and downs in the market, we are always surprised when an economic downturn hits. Historically, this has led to overconfidence in our ability to correct the problem. Consider four acts of Congress that were designed to prevent any future breakdown in the financial sector or housing industry:

- the Financial Institutions Reform, Recovery and Enforcement Act of 1989;
- the FDIC Improvement Act of 1991;
- the Housing and Community Development Act of 1992; and
- the Housing Financial Safety and Soundness Act of 1992.

After the passage of these acts, Treasury Secretary Nicholas Brady said of the current economic downturn, “This will never happen again.”[10] He was proved wrong less than a decade later with the onset of the dot-com bubble and again with the housing bubble (see nearby chart). Despite the need for change, regulators should know their limits before going about the process of creating a 21st century regulatory structure.



Source: Yahoo! Finance NASDAQ Historical Price List

Regulation writers have plenty of information about the past, but little about the future. Decisions of banks and investors in the past are known and documented; decisions those same actors will make in the future are unknown. There is a limit to the knowledge regulators have available. And writing regulations based on the past won't necessarily solve problems in the future. Resilient regulations, on the other hand, can offer significant insulation and shock absorption. Rather than trying to counter and control every anticipated market fluctuation, resiliency strengthens the ability of the market as a whole to withstand natural fluctuation and right itself, to the benefit of the market as a whole.

Another problem regulation writers face is demand for a quick reaction and speedy regulatory solutions. Congress plans to take up the regulation issue in September and the president has made it clear that he wants a bill passed by the end of the year. Moving quickly has political advantages, but it can result in bad laws. There is no predefined time frame that Congress should use to consider new laws. Congress does not necessarily need to wait a full year to assess the crisis, but neither can 100 years of financial sector regulations be fully rewritten in a three-month process without negative consequences.

Rapidly shaking up the regulatory structure is a product of overreaction and often results in a failure to take the time to consider long-term consequences. With an emphasis on winning temporary battles, it sets the stage to lose the war. Overreaction tends to stem from political pressure to act quickly, not from the desire to facilitate competition. The fear that government will overreact is widespread. Niall Ferguson wrote in *The New York Times Magazine*, "In the months ahead, the world will reverberate to the sound of stable doors being shut long after the horses have bolted, and history suggests that many of the new measures will do more harm than good."[11]

One such measure was the highly acclaimed Housing Financial Safety and Soundness Act in 1992, which required Fannie Mae and Freddie Mac to issue more subprime loans, eventually inflating the cost of housing in rural areas.[12] An example of overreaction to the current economic crisis would be banning subprime loans completely. As problematic as the securitized subprime mortgages have been for financial institutions, the larger issues were reduced lending standards and excessive accumulation of debt. There is an appropriate market for lending to low-income borrowers, but a hasty response might ignore this.

In response to the Administration's push for a quick resolution of regulatory reform, George Mason economist Tyler Cowen pointed out that the best regulation "comes through many years of experience and gradual process improvements, built upon some reasonable methods for imposing regulatory accountability. That's how the FDIC got to be good at much of what it does. Better regulation does not come from sitting down, waving a wand, and hoping that a new name or box will address the problem you are concerned about."[13]

D. The Myth of Deregulation

Rapidly written regulation that overreacts to an economic crisis is particularly damaging when based on a misdiagnosis of the causes of a recession. One frequent misdiagnosis is the myth that deregulation of the financial sector created a system of excessive risk and irresponsibility. Although this has become conventional wisdom, there is little historical evidence to back up the claim. Ultimately, the data point to *bad* regulation as a cause of the financial crisis, not *de*regulation.

Over the past 30 years there have only been three major financial deregulatory actions. The modern era's first major Wall Street deregulation was the Depository Institutions Deregulation and Monetary Control Act of 1980. This law repealed so-called "Regulation Q ceilings" that limited the amount of interest consumers could earn from savings and checking accounts. The law also expanded the types of financial institutions that could get overnight loans from the Federal Reserve discount window.

Since letting banks pay interest to their customers encourages saving and the use of depository institutions, this aspect of deregulation certainly can't be blamed. And though it could be argued that an increased number of financial institutions being able to borrow money partially allowed for the housing bubble, that money was being borrowed from the Federal Reserve—hardly deregulation. And that doesn't even begin to address the fact that there have been multiple recessions and bubbles since this law was passed.

The second major deregulation was the Garn-St. Germain Depository Institutions Act of 1982. This authorized banks to compete with money market mutual funds. This legislation has also been linked to today's crisis because it loosened restrictions on issuing mortgages, allowing for the development of subprime loans.

However, it wasn't Garn-St. Germain specifically that created the subprime mortgage bubble; it was produced by the government policies that created perverse incentives—namely policies that promoted homeownership to low-income, unqualified borrowers, the Community Reinvestment Act, excessive risk taking by Fannie Mae and Freddie Mac issuing billions in mortgage-backed securities with the taxpayers as a safety net, and the implicit policy of too big to fail leading mortgage originators and private sector securities investors to excessive risk-taking. The relaxation of mortgage-lending standards is not inherently a bad thing. Tighter standards might have reduced the number of subprime mortgages weighing down bank balance sheets, but it would have also reduced the flexibility of banks to lend to good credit risks that were outside previously established standards.

Garn-St. Germain should have allowed banks more freedom to compete with mutual funds while also clarifying that the role of the FDIC was only to insure deposit losses. However, it failed, along with other regulations, to outline the government's role in the event of financial institution failure. The decreased standards, coupled with an implicit government guarantee for firms too big and interconnected to fail, skewed the risk assessment process of financial institutions. The promise of rescue was much more damaging than loosened lending standards.

The third deregulation blamed for causing the financial crisis is the Gramm-Leach-Bliley Act of 1999 that partially repealed the famed Glass-Steagall Act. The original Glass-Steagall Act passed in 1933 had kept deposit-bearing banks and investment banks from competing with each other for over six decades. After this repeal, banks were able to maximize their resources and many grew large enough to be classified "too entwined to fail." Problems began to emerge from associated regulations related to the heightened interconnectedness of financial institutions. Guaranteed to survive, they were encouraged to gamble irresponsibly.

Had mark-to-market regulations been more flexible, banks would have had more time to raise capital and sell assets. Had Wall Street firms not seen Washington as a lender of last resort that would bail out investments gone awry, they would have managed their risk better. Had capital reserve ratios been higher, banks and investment institutions would have had more liquidity when prices dropped (though some firms, like AIG, simply became insolvent and wouldn't have been saved by higher reserves). Or, if qualified special purpose entities—i.e., an off-balance sheet accounting method—had required more transparency, banks would have had to keep more risky mortgages on their books, making them subject to reserve requirements.

Indeed, even if these three deregulations were linked to the current financial crisis, they would still hardly constitute a historical trend. In contrast, historical periods of high regulation have proven decidedly unfavorable. Financial sector regulation during the 1970s was much heavier than it is today, and that did not prevent Stagflation, with unemployment reaching 9 percent in May 1975 and inflation nearly topping 14 percent.

Similarly, Europe currently boasts some of the world's tightest financial sector regulations, and its banks have suffered just as much, if not more, than American banks in this recession. Strict financial regulations that are specific to Europe include higher capital reserve ratios, heavier oversight from state firms for banks, and more reporting requirements for financial institutions. European governments have heavy influence over bank operations and there is the added regulatory level of European Union agencies. Yet European banks made the same bad bets, the same poor investments and the same over-leveraged mistakes as American banks.

E. Failed Regulation

Despite the fact that *de*regulation didn’t cause the crisis, there were problems with the regulatory structure in America during the bubble period. The important distinction is that failure by deregulation would naturally yield increased layers of bureaucracy to compensate for the lack of laws. In contrast, an analysis of the bad regulations that existed during the bubble period can show how anticipation regulation doesn’t solve all problems and can create more. Historical review reveals that bad regulations on the books, a lack of reforms and regulatory agency failure were the key aspects of regulatory failure.

An example of bad and ineffective regulation is easily found in the Sarbanes-Oxley Act of 2002, also called “Sarbox.” Passed by Congress in the wake of the Enron and World Com scandals, the goal of this legislation was to prevent future corporate fraud, increase accountability for managers and strengthen the role of regulators in auditing. However, as Henry N. Butler and Larry E. Ribstein write in a revealing study, Sarbox was “a colossal failure, poorly conceived and hastily enacted during a regulatory panic… Given the efforts of pro-regulatory interest groups and sensationalist news media reports of corporate fraud, it is not surprising that Sarbox was enacted.”[14]

Sarbox essentially increased compliance regulations, required more reporting, and instituted new rules for investor protection. But Butler and Ribstein write, “it was not clear what, if any, problems needed fixing [after Enron and World Com], or how new regulation could solve them.”[15] More laws won’t stop people from committing fraud, as the Bernard Madoff ponzi scheme proved.

Sarbanes-Oxley has destroyed value at companies by increasing their compliance costs. Butler and Ribstein also write that investors will only find regulation valuable “if the benefit from reduced fraud is greater than the cost of compliance by the firms they invest in.” Given the Sarbox compliance costs, the mandates have turned out to be a terrible deal for the ordinary investors it purports to protect.”[16]

A lack of reforms contributed to regulatory failure just as much as failed regulations. The Community Reinvestment Act, initially passed in 1977 though revised eight times since then, was used by Congress to push government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac to lower underwriting standards and issue more low-income mortgages. Private banks and mortgage originators were engaging in the same practices, though the largest issuers were the two quasi-private, taxpayer-backed agencies. This was one of the leading causes of the housing bubble.

During the George W. Bush presidency, the Administration and Congress failed three times to reform Fannie and Freddie and reduce their rapidly growing liabilities. Even after an accounting scandal in 2003, the government did little to correct the growing problem and instead issued affordable housing quotas. President Bush's budgets in 2001 and 2005 warned of excessive leverage and inadequate capital reserves at the GSEs, though nothing was done. Even Treasury Secretary John Snow was ignored when he called for GSE reform. Addressing the problem of Fannie and Freddie would have dramatically decreased the negative impact of the housing bubble and might have dampened the impact of the financial crisis.

Not only did Congress and the presidency fail to make the right reforms, the regulatory agencies themselves failed in their roles. Richard Fisher, President of the Federal Reserve Bank of Dallas, told *The Wall Street Journal* in May 2009 that the regulators had enough authority to prevent a crisis. They simply failed. "The regulators didn't do their job," he said, "including the Federal Reserve."[17] Debates remain over whether former Fed Chairman Alan Greenspan should have kept regulatory policy loose, but the fact is that the agency missed the development of the housing bubble and responded too late by bringing interest rates to market levels.

SEC Chairman Mary Schapiro also admitted her agency failed during the bubble period (though from August 2005 to January 2009, the SEC was chaired by Christopher Cox). In a June 2, 2009 testimony before a Senate subcommittee on financial services, Schapiro said,

> *What I have also discovered in the past four months is that much attention needs to be focused on the internal operations of the agency, the processes that guide our work, the agency's infrastructure and how we are organized. I have been disappointed to find that in some areas of our internal operations, we fall short of what the taxpayer has a right to expect of us, and what our employees have a right to expect of a world class organization.*[18]

The admissions by the Fed and SEC highlight a historic trend of regulators not being able to keep up with rapidly innovative types of investment vehicles. This is one of the weaknesses of regulation that tries to anticipate every possible problem instead of being able to flex with the changes in the market. Some financial products have become so complex that the top executives of Wall Street's banks don't understand how they work, much less the regulators who are supposed to monitor financial activity.

New regulations must focus on creating incentives for regulators to do their jobs well and ensuring that they have the proper resources to accomplish their tasks. This doesn't necessarily mean lots of new rules. What is most important is that agencies work on enforcing the rules that exist now.

The SEC is already taking steps toward this goal. Schapiro told the Senate Subcommittee: "Our Office of Compliance Inspections and Examinations, together with other agency staff in the Office of Risk Assessment, are presently working on an initiative to identify the key data points that would facilitate an improved risk-based oversight methodology to allow the staff to identify and focus on those firms presenting the most risk."[19] The SEC has also announced plans to hire a chief operating officer, speed up responses to information requests, and improve its call-center operations. All of this has come without legislation, and is an example of organizations working to improve themselves in response to revealed flaws.

F. Define the Role of Government

The largest failure of the regulating agencies, including the Treasury Department and congressional oversight committees, was the implicit guarantee of a bailout for banks considered too big and interconnected to fail. Historical precedent created a general feeling on Wall Street that, given the entwined nature of the financial system, the federal government would not allow a major bank or investment firm to fail. However, this was not explicitly stated, making it unclear as to when bankruptcy law would be used for failing institutions and when bailouts would be the preferred government action.

Previous bailouts of Chrysler in 1979, Continental Illinois National Bank in 1984, and an orchestrated private bailout of Long-Term Capital Management in 1998 were just part of the reason banks believed they would be bailed out if their investments went too far south. Governance of financial markets is one of the most intensive public sector supervisory structures, with regulators closely engaged with firms, both from the outside and within. Insider accounts, like those provided by William D. Cohen in his Bear Stearns exposé, *House of Cards*, reveal intimate conversations between executives and their regulators that led to the justified belief that the government would be there to support them if bankruptcy was imminent.[20]

Facing the imminent threat of bankruptcy, Bear Stearns CEO Alan Schwartz and CFO Sam Molinaro met with Wall Street lawyer H. Rodgin Cohen to discuss alternatives:

> *"They batted around different ideas about what could be done to help Bear Stearns, including considering whether private equity firms or commercial banks might be able to put together a solution quickly. But soon enough they concluded there was just one answer. 'The only people who can do anything about this are the Fed,' Cohen recalled saying to Schwartz and Molinaro. 'So that's when I did call Tim Geithner about it very late at night.'" – House of Cards[21]*

The implicit too-big-to-fail guarantee dramatically impacted the risk assessment of financial institutions. They became highly leveraged with billions in subprime loans on their balance sheets because the up side was massive profit. This excessive risk-taking was rationalized by the possibility of running to Washington D.C. for a loan if their bets turned sour. Therefore, blame falls on the government for not clarifying its role or the consequences of failure.

Banks hate regulatory ambiguity because they don't know what is permissible and what will be condemned. Imagine the confusion of Lehman Brothers, allowed to fail, after the bailout of Bear Stearns and then AIG. Banks can develop systems and policy to adhere to regulation. If they do it well it can be a competitive advantage. Clarity of roles, responsibilities and expectations of the regulators is also helpful for investors, so that the market knows where the government is going to step in and where it won't. This helps to determine how to diversify a portfolio and how to assess the risk of the investment.

Transparency also allows for public debate of government-created rules. The White House's regulatory proposal essentially suggests accepting too-interconnected-to-fail policy as unavoidable and provides a mechanism for future bailouts. Having that suggestion on the table allows for interested parties to debate the merits and problems with the regulation.

Former Federal Reserve Chairman Alan Greenspan said in a June 3, 2009 speech that the implicit subsidy too-big-to-fail thinking spawns "insidiously impairs the efficiency of finance and the allocation of capital." The government guarantee of protection from failure skewed the risk assessment process that aids capital efficiency. Greenspan added that too-big-to-fail policy

> *…results in protected businesses having market and cost-of-capital advantages, but not efficiency advantages over firms not thought to be too big to fail. TBTF freezes obsolescent capital in place and impairs creative destruction—the primary means by which output per hour and standards of living are raised.*[22]

Greenberg was pointing out that the market is a profit *and loss* system. Failure is a necessary part of growth. Successful business ventures will move forward and others will be destroyed to make room for more to be created (i.e., creative destruction).[23]

Ultimately, the government will need to make a choice about what its role in the financial sector will be. How interconnected does Washington want to be on Wall Street? Should taxpayer dollars bail out important financial institutions? Can regulators be all-knowing and successfully anticipate future problems or should regulations be made flexible to absorb losses in the future? These questions about the role of government are what Congress will take up as it works through a regulatory reform bill to determine how to change the structure of today's financial sector regulations.

Part 3

The Current Regulatory Framework

Financial sector regulators are both public and private, each with its own jurisdiction and given role, although these have lately become obscured. Here are the key regulators and their current distribution of authority:

A. The Federal Reserve

The Federal Reserve System (Fed) is a unique, hybrid-government agency that unites 12 private, regional banks around the country to form a central bank system largely separated from the political apparatus of Washington D.C. The Fed was created in 1913 after several decades of mini-financial crises led Congress to establish a stabilizing force overseeing bank holding companies. The Fed has the power to set monetary policy by determining interest rates, controlling the money supply and establishing reserve requirements for financial institutions. The seven-member Fed Board of Governors, who guide the central bank, are appointed by the President and confirmed by Congress to fourteen-year terms. However, the presidents of the 12 Federal Reserve Banks are independently elected rather than appointed by Congress. This structure is important to note because it was intentionally designed to remove monetary policy from political conflicts of interest. In the current regulation debate, some have suggested that bringing the Fed under closer congressional supervision might compromise this important measure of central banking independence. While a legislative audit of the Fed could add a valuable layer of accountability, having Fed bank presidents appointed by Congress would bring substantial political concerns into the development of financial policies.

B. Securities and Exchange Commission

The Securities and Exchange Commission (SEC) was created in 1934 at the height of the Great Depression to "restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing." In short, it is the police of Wall Street. The SEC sets rules for how trades can be made, establishes disclosure procedures and prosecutes persons or firms that commit fraud. It is charged with protecting investors from fraud, ensuring that investors have access to accurate and timely data about companies, and to oversees mutual funds. Its mission today is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."

C. Federal Deposit Insurance Commission

The Federal Deposit Insurance Commission (FDIC) was created in 1933 in the wake of the bank runs that caused thousands of bank failures in the late 1920s and led to the Great Depression. Its mission is "to maintain stability and public confidence in the nation's financial system by: insuring deposits, examining and supervising financial institutions for safety and soundness and consumer protection, and managing receiverships." Nearly all banks are "FDIC Insured," meaning that if they go bankrupt, the government will make sure that depositors get their money back (up to a certain amount). Furthermore, when a bank fails, the FDIC takes it into "receivership" (essentially a form of nationalization), does what is necessary to protect customers and employees, and sells the bank's assets to the private sector.

D. Treasury Department

The Treasury Department (Treasury) has long been both a policy-making and enforcement arm of the executive branch for economic activity including the financial sector. Its mission, beyond managing government finances, is to serve the American people by "promoting economic growth and stability, and ensuring the safety, soundness, and security of the U.S. and international financial systems." The Treasury has oversight over national banks and lending institutions, power to investigate and prosecute tax evaders, counterfeiters and forgers, and the responsibility of enforcing federal finance and tax laws. Within the Treasury are the Office of the Comptroller of the Currency (OCC) that oversees all national banks, and the Office of Thrift Supervision (OTS) that regulates savings and loans operations at banks.

E. Financial Accounting Standards Board

The Financial Accounting Standards Board (FASB) is a private organization, created in 1973, made up of economists and accountants who set specific day-to-day operating standards for the industry. Accounting standards are a critical component of financial stability because they increase the flow of information from companies to the market by providing a recognized structure for competition.

F. Other Agencies

Other agencies with oversight include the Federal Housing Finance Agency (FHFA), which was created July 30, 2008 by the Housing and Economic Recovery Act to oversee Fannie Mae, Freddie Mac and the Federal Home Loan Banks, and the Commodity Futures Trading Commission (CFTC), which regulates commodity futures and option markets by ensuring the financial integrity of the clearing process and prosecuting fraud, manipulation and abusive trading practices. The National Credit Union Administration (NCUA) supervises all federally chartered credit unions and operates the National Credit Union Share Insurance Fund for all federal credit unions and most state-chartered credit unions.

Part 4

The White House Overhaul Proposal

A. Themes in the Obama Regulation Proposal

President Obama addressed the question of the role of government in financial services regulation throughout his proposal for reform. Over time the specific roles, responsibilities and expectations of the various regulators have become blurred. Clarifying the exact roles of each institution—both for day-to-day governance and for times of crisis—would promote more effective execution of duties and ensure that banks and investors understand the consequences of their investments. This is what the Obama proposal attempts to do.

By any objective standard, the White House has proposed the largest expanse of regulatory power since the Great Depression, from creating a council to oversee systemic risk to expanding the powers of the Federal Reserve to requiring hedge fund and private equity pools to register with the SEC for the first time in history. The proposed expansion is built around five basic policy objectives:

- Promote robust supervision and regulation of financial rules;
- Establish comprehensive regulation of financial markets;
- Protect consumers and investors from financial abuse;
- Provide the government with the tools it needs to manage financial crises; and
- Raise international regulatory standards and improve international cooperation.

Woven throughout this five-point skeleton are dozens of recommendations that carry some basic themes. The most profound theme is the absence of blame on the government for playing any role in the financial crisis. The beginning of the president's white paper discusses the failures of banks to maintain responsible lending standards, manage debt and be prudent when securitizing loans. The paper never mentions the role the government played in passing bad regulations, missing reform opportunities or skewing risk assessment processes through the tacit too-big-to-fail guarantee. The president's proposals are designed according to the perspective that all blame for the financial crisis rests with the private sector.

A key theme in the paper is that increased knowledge will prevent future problems in the financial sector. Many of the proposals are dependent on attaining perfect knowledge of future events. It is assumed, somewhat correctly, that the more regulators know, the better they will be able to regulate. However, the proposal assumes that all knowledge can be collected and properly analyzed without addressing the failure of agencies like the SEC to analyze the limited data they received during the period preceding the current crisis. The SEC admitted it ignored warnings about Bernard Madoff's potential ponzi scheme and chose not to follow up given its limited resources.[24]

Another theme in the regulation proposal is the necessary trade-off between wealth creation and stability. Any time regulations are increased on financial products, compliance costs go up, decreasing the time and resources a firm can use to create wealth. However, those regulations are intended to "stabilize" the market by anticipating future problems. There are always trade-offs to some degree with regulation; the debate here is over what costs are acceptable in exchange for the perception of increased stability. (Regulators should remember though, that real stability isn't possible given it is impossible to anticipate every future economic problem. All we can get is the perception of stability in a risk-taking environment.)

The White House proposal also assumes that the role of government is to prevent failure when possible. This theme stretches from the creation of a resolution authority to powers given to the Federal Reserve in managing systemic risk. The powers and roles of the Federal Reserve would be dramatically increased by the proposal, with additional authority being given to the SEC as well.

The president's financial services reform proposals and the five policy goals fall into three categories: new agencies, the regulation of new sectors of the market, and increased regulatory measures. This paper will now analyze the major policy proposals in the white paper, using these three categories as a guide.

B. New Agencies

Financial Services Oversight Council

Obama Plan: Establishes the Financial Services Oversight Council that will monitor the financial markets and determine if firms should be placed under newly designed "Tier 1" regulations; gives power to the Federal Reserve to enforce Council decisions and be responsible for stopping firms from becoming systemic risks.

The Administration blames the financial crisis on a lack of liquidity due to insufficient capital reserve requirements, over-leveraged financial institutions, fragmented supervision of banks, and a lack of oversight for hedge funds, investment banks and mutual funds. The White House proposal deals with each one of these issues separately, but together they all serve as a basis for the proposed Financial Services Oversight Council. This Council would be chaired by the Treasury Secretary and be composed of the Fed, SEC, CFTC, FDIC, FHFA, the National Bank Supervisor (new agency), and Consumer Financial Protection Agency (new agency). A permanent staff for the Council would be housed in the Treasury Department, though it would interface more closely with the Federal Reserve than other agencies.

"Macroprudential analysis" is the technical analysis used by regulators to evaluate the health of financial institutions and systemic vulnerabilities. Taking a macroprudential view of the market is to trying to determine how all financial institutions are faring and if problems exist that might affect everyone.

The Council would be able to take a wide, "macroprudential" view of the financial sector to ensure regulations are applied consistently, coordinate regulating agencies to fill gaps, and identify emerging risks. The Council would also have authority to collect whatever information it needed from financial institutions to evaluate their potential risk to the system.

With this wide view, the Council would have the authority to determine if specific firms should be considered too interconnected to fail. Financial holding companies (FHC) whose failure could threaten financial stability due to size or interconnectedness would be deemed Tier 1 FHC institutions by the Council and subjected to the highest level of regulation and oversight.

The tiered structure for determining what level of regulation an institution would incur would be based on five core criteria set out in the White House's systemic risk draft legislation sent to Congress in late July:

1) The amount and nature of the company's financial assets;
2) The amount and types of the company's liabilities, including the degree of reliance on short-term funding;
3) The extent of the company's off-balance sheet exposures (previously, this was largely unmonitored);
4) The extent of the company's transactions and relationships with other major financial companies; and
5) The company's importance as a source of credit for households, businesses and state and local governments, and as a source of liquidity for the financial system.

This set of criteria is currently very vague, but there is likely to be more detail added once the House of Representatives and the Senate mark up the draft legislation. The Council would determine to what degree these criteria would be assigned, and would also have the power to add additional criteria at its discretion.

The Federal Reserve would be responsible for enforcing whatever regulations are levied against institutions that fit these criteria. In this way, the oversight for any firm considered too interconnected to fail would fall within the authority of the Fed. The Federal Reserve would also have authority to use funds to stabilize the market in the case of a systemic risk emergency.

To fulfill these new tasks, the Council and the Fed would need access to continuous, free-flowing information about all financial institutions. Complicating this is the enormity of macroprudential oversight of the entire American economy. The IT infrastructure for this quantity of information sharing has never existed and would go through several phases before becoming fully operational. And an additional hurdle to clear with this critical component of full-scale oversight would be getting institutions (particularly previously unregulated hedge funds) to open themselves completely up to regulators, especially considering concerns about the protection of proprietary information.

This part of the proposal essentially attempts to codify bailouts and too-big-to-fail policy. The House Republicans released a counter plan for reforming financial services regulation and also proposed a “Stability Board.” The difference is that the Board would not have the power to classify firms as too large and interconnected to the financial industry to be allowed into bankruptcy if they failed.

Some have voiced concern over the Federal Reserve’s ability to handle the enforcer role for the systemic risk Council. Senator Richard Shelby (R-AL), ranking member of the Senate Banking Committee, noted in a hearing on the regulation proposal that the Fed plays various roles, including setting monetary policy, monitoring bank regulation and providing consumer protections. He told Secretary Geithner at that hearing, "These responsibilities conflict at times and some receive more attention than others. I do not believe that we can reasonably expect the Fed or any agency to effectively play so many roles.” Secretary Geithner responded that he did not believe there was a plausible alternative to the Fed for this role.[25]

Former Deputy Comptroller Robert R. Bench also has voiced reservations about the effectiveness of an oversight Council. He argues, “It inherently has been the mission of the Federal Reserve to carry out surveillance of the macro economy and the financial system, both domestically and globally. The Fed has an army of economists and bank examiners deployed to that cause already.”[26] In any case, the core challenge a Council and empowered Federal Reserve face is the knowledge problem. Even with an army of economists, it is impossible to anticipate every potential risk to the system.

National Bank Supervisor

Obama Plan: Establishes the office of National Bank Supervisor, consolidating all federal banking regulation into the new agency; ends federal chartering of thrifts; removes restrictions on interstate banking.

Safety and fiscal stability of banking institutions is currently overseen by four agencies: the Federal Reserve, the FDIC, the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC). The White House is proposing the creation of a National Bank Supervisor (NBS) with oversight of all federally chartered banks. This new federal agency would absorb the entire OTS and the bank supervision duties of the OCC. The Fed and FDIC would continue to supervise state banks, and the National Credit Union Administration (NCUA) would continue to oversee credit unions.

Consolidating all bank regulation into a single agency would reduce gaps in oversight of conglomerated firms whose subsidiaries are governed by different regulators. And it would give the regulating authority a better macro perspective on the health of the banking industry to aid the Federal Reserve in oversight of systemic risk.

The White House also proposed ending the federal charter for thrifts to consolidate the types of bank institutions. Additionally, the president's plan calls for the elimination of restrictions on interstate branching for federal and state banks, allowing for banks to set up a branch anywhere else in the country.

Republicans in the House of Representatives proposed an alternate solution, creating a Financial Institutions Regulator (FIR) for all federal and state deposit-bearing institutions. This FIR would consolidate all banking supervision powers of the Fed, NCUA, OTS and OCC. This has a similar unifying effect of the Obama plan for banking regulation, though it expands the federal government further by pulling state banking regulation into the responsibilities of its agency.

Some argue that consolidating all banking regulating authority into a single agency will create a one-size-fits-all regulation approach. The NBS or FIR would be tempted to issue standardized rules for all different types of federal and state banks. Other critics argue that the current structure allows for competition between regulating agencies as firms can often choose which agency with overlapping authority to work under.

Consumer Financial Protection Agency

Obama Plan: Establishes the Consumer Financial Protection Agency to regulate financial products, including mortgages and credit cards; the stand alone agency will have the power to set standards for those same product types and be able to reject products that are deemed too complicated or dangerous for other reasons.

One of the main policy objectives of the Administration is to reform financial product protections for consumers. To meet this objective, the White House has proposed the creation of a Consumer Financial Protection Agency (CFPA). This new federal agency would be tasked with protecting consumers from "unfair, deceptive, and abusive practices" of credit card companies, mortgage lenders, commodities traders, mutual fund brokers and other firms that originate products.

On July 8, 2009, the White House sent draft legislation to Congress that would establish a CFPA and assign it with full oversight for protecting consumers, including taking away the Fed's role in consumer protection, one of the few transfers of power away from the central bank. The mission of the agency would be "to seek to promote transparency, simplicity, fairness, accountability and access in the market for consumer financial products or services."[27]

As the bill currently stands, the proposed agency would be responsible for enforcing all previously passed legislation regarding consumer protection and would assume the consumer protection functions of the Fed, OCC, OTS, FDIC, Federal Trade Commission and NCUA. The Federal Reserve has argued that banking regulation and consumer protection regulation are complementary activities, and one informs the other. Fed Chairman Bernanke believes that consumer protection decisions made in a vacuum would distort market activity and harm business profitability.

This consumer protection agency for financial products would work similarly to other government agencies that create rules to protect consumers, like the FDA or FTC. The president's proposal would let the CFPA set mortgage rules, write rules for all financial institutions, supervise and examine companies for compliance, and set fines and penalties for delinquency. The plan would also increase transparency requirements and create higher standards for consumer-related financial products. These include more easily understood and more concise mortgage contracts and credit card commitments. The agency would be partially funded by fees and penalty assessments.

Nearly every financial industry group has lined up in opposition to the proposed Consumer Financial Protection Agency. The idea of a CFPA has sparked intense criticism from the U.S. Chamber of Commerce, which believes this agency would step on the toes of existing regulators and discourage consumers from doing their own research into the benefits and risks of a product. President of the USCC's Center for Capital Markets Competitiveness David Hirschmann said, "We do worry that if there's product-by-product approval by a stand-alone consumer protection agency, it will imply to consumers that these products are safe and that they don't have their own responsibilities for due diligence."[28]

Others believe rules coming out of the CFPA would be counter to actual consumer interests. The recent Credit Card Responsibility Accountability and Disclosure Act (CARD) is an example of what kind of regulations might come out of a CFPA. The CARD bill tries to protect consumers by restricting the way companies can charge interest, requiring simpler contract language, and restricts the types of fees lenders can use. The unintended consequence of this regulation has been an increase in the cost of credit, and limits it to others (particularly to the low-income class), since firms can no longer charge market rates. Many fear the CFPA could do similar damage to other types of financial products.

Another problem that critics point to is that the CFPA would have the power to design very simple, very limited "plain vanilla" versions of financial products and force firms to offer them in addition to their self-designed products. The CFPA would also have the power to ban certain products and require that firms offer the CFPA's "safer" alternative alone, leading many to oppose this creation of a government entity that would wield the power to both compete with the free market and to ban its competition.

Still other critics believe a CFPA would simply be ineffective. Finance and business editor for *The Atlantic* Megan McArdle wrote in June 2009,

> *The problems that are now bringing consumers low are not the things hidden in the fine print. They're the things that were right out there on the front page: their interest rate. The size of their loan relative to their income. The fact that the interest rates on adjustable rate loans can adjust upward. The people who took out Option ARMs or borrowed $40,000 in credit card debt on a $45,000 income were not unaware of these things. They ignored them. [The CFPA is] not a terrible idea, but I'm skeptical that it will have any effect.*[29]

Banks are concerned that the consumer protection agency, which would not be in tune with other aspects of the market, as the Fed is in its consumer product oversight role, would dramatically increase the costs of compliance (similar to Sarbanes-Oxley). Still, advocates for a CFPA believe that consumers were hurt during the crisis by complex mortgage agreements and confusing investment products and believe an agency is necessary to bring stability to the financial products market.

Finally, critics also argue that, even considering documented abuses by financial institutions, the need for more consumer protection laws is unnecessary. While predatory lending did exist during the development of the housing bubble, it wasn't popped by the reset of adjustable rate mortgages spiking interest payments through the roof. Though this did start happening on many mortgages, foreclosures started before this as prices began to drop.

Furthermore, many of the complaints about "evil" practices of financial institutions are often times the fault of the consumer. Overdraft fees, high interest payments for credit, and other costs in the fine print serve an important role in rationing credit and protecting companies from abuses by consumers who don't pay their bills on time or who constantly overdraft accounts. Pro-CFPA advocates respond that just because some consumers may complain inappropriately does not mean the system doesn't need reform.

Resolution Authority

Obama Plan: Creates a resolution authority to nationalize failing non-bank financial institutions in order to prevent systemic damage; funding for the resolution authority is yet to be determined by Congress; failing banks will still be protected by the FDIC.

In order to manage the economy in financial crisis, the White House has proposed the creation of a resolution authority to work with the FDIC to deal with failing Tier 1 FHCs and other major banks. The goal of this proposal is to clarify the role of government and provide a statutory framework that avoids the uncertainty that accompanied the impending failures of Bear Stearns, Lehman Brothers and AIG.

Currently, the FDIC can only take failing bank holding companies into receivership (as it did with IndyMac Bank in March 2008 and Washington Mutual very briefly six months later), but not other financial institutions such as hedge funds, insurance agencies or other investment firms. This proposal would grant the resolution authority special powers to take over any problematic financial institution labeled Tier 1 and break it apart or limit its activities.

The largest challenge this proposal faces in Congress is how it will be funded. The FDIC collects premiums from banks that pay to have their deposits insured. That money is used to take over failing banks and run them until they are sold. It would not be as simple to fund a pool of money to cover a number of large investment firms and potentially all non-bank financial institutions. Either all firms will need to pay into an insurance fund—whether they want the insurance or not—or tax revenues will fund the authority.

The most likely scenario is all Tier 1 firms would pay the same fee into a pool no matter what their size and would be given equal treatment. This is the model that credit unions use with the National Credit Union Share Insurance Fund.

Congressional Republicans have proposed a counter idea to the resolution authority. Arguing that the resolution authority will retain the policy of too big to fail, the GOP has proposed a new type of bankruptcy law to help wind down distressed non-bank financial institutions. Their plan would create a new Chapter 14 bankruptcy proceeding that would build on Chapter 11 law by expediting the hearing process. The point of relying on bankruptcy is explicitly because the GOP believes a resolution authority "could place politics over sound regulation and give firms the incentive to grow even bigger."

Office of National Insurance

Obama Plan: Establishes the Office of National Insurance to regulate all aspects of the insurance industry; places large insurance companies under Tier 1 regulation to prevent systemic risk.

The insurance industry makes up nearly a third of all financial sector jobs. With $5.7 trillion in assets in 2008, compared to $15.8 trillion in the banking sector, the insurance industry is a significant part of the financial system. Insurance companies are regulated state to state, resulting in a lack of legal uniformity. The president's white paper states that this reduces competition across state lines, results in higher costs to consumers because of inefficiencies, and reduces product innovation.[30] This lack of regulatory consistency made it difficult for regulators to determine how to respond to the collapse of AIG, America's largest insurer, in 2008.

To remedy this situation, the White House proposes a new division within the Treasury Department, the Office of National Insurance. This new bureau would work to develop a modern regulatory framework for insurance, monitor all aspects of the insurance industry, identify regulation gaps that could pose systemic risks, and determine if any insurance agencies should fall under the Federal Reserve's Tier 1 FHC category of regulation.[31]

The Obama white paper suggests that a modern insurance framework should ensure that insurance companies do not pose a systemic risk to the rest of the financial system, establish strong capital reserve requirements relative to each company's liabilities, protect consumers from confusing and predatory insurance policies, and unify the insurance regulatory structure with a federal charter or state reforms. However, the president has not explicitly supported the idea of a federal charter option for insurance, which some critics complain is a weak point.

The current structure allows states to ensure that insurance companies are meeting the specific needs of their citizens, allowing insurance companies flexibility to act in customized regulatory environments. However, this has lead to inefficiencies, and complications for insurance companies who have to navigate different laws state to state. Some argue that state charters allow for competition between states, but regulation writers will have to weigh both sides of the trade-off between that and market inefficiencies.

C. Regulating New Sectors of the Market

Hedge Funds and Private Equity Oversight

Obama Plan: Requires hedge funds and private equity groups to register with the SEC; has the systemic risk Council determine if any hedge funds pose a systemic risk and subjects them to Tier 1 regulations.

Traditionally, hedge funds have not been subject to mandatory regulatory oversight. The investment firms were originally created on the fringe of the market as a way to balance portfolios and let investors have more risk-based choices. However, over the past few years, hedge funds have increasingly become an important part of the financial infrastructure, especially the large ones. As part of the policy goal to establish comprehensive oversight of everything in the financial sector, the president has proposed requiring hedge funds, private equity funds and venture capital funds to register and report to the SEC.

Currently, investors that trade commodity derivatives register with the Commodities Futures Trading Commission. Other funds voluntarily register with the SEC. And under current law these funds are still subject to prosecution if they defraud their clients. The White House proposal would essentially bring everyone else, down to a certain "modest threshold," under the umbrella of oversight so that the Council could assess potential threats to financial stability.[32] Secretary Geithner has added that proprietary information would be respected.[33]

Hedge funds can be large, with hundreds of millions under management, or be smaller and more specialized. Critics of the plan point out that only a few hedge funds are large enough to make any kind of a ripple in the financial sector. Bringing them in might actually increase risk potential. Hedge funds have a high rate of failure in normal market conditions, and giving them the protection of government guarantees by declaring them systemic risks will not decrease risk-taking behavior. The White House will have to establish how the failure of hedge funds could impact systemic risk.

Former Federal Reserve Chairman Paul Volker, a close advisor to the president on economic issues, believes that the few, largest hedge funds should be subject to reporting requirements and fall within the reach of the proposed resolution authority. But for the majority, he does not believe that there is a positive gain from comprehensive registration requirements. In a June 11, 2009 speech at the International Institute of Finance in Beijing, Volker said, "Hedge funds and private-equity funds have an entirely legitimate role to play in providing liquidity and innovation in our capital markets. I do not believe they need to be so closely supervised and regulated as depository institutions."[34]

Another concern is, again, compliance costs. The Administration's position is that the trade-off of lost value from compliance does not outweigh the gains of safety and stability for the market. Yet small hedge funds with only a few clients and staff don't want to spend two days a week filing forms. The president did not establish a capital management threshold for requiring reporting in the white paper, instead leaving the decision to Congress. Regulation writers must understand that compliance costs for small hedge funds would cause many of them to close down.

Over-the-Counter Derivatives, Futures Contracts and Securities

Obama Plan: Establishes an open exchange for derivatives, futures contracts and securities; encourages the standardization of contracts; creates a central authority to clear trades to provide more transparency; increases margin requirements for customized derivative contracts.

The often misunderstood financial products loosely grouped as over-the counter (OTC) derivatives have been intensely vilified as culprits in the creation of the financial crisis. These products, including credit default swaps, are unique financial vehicles that give consumers and governments a wide range of investment and insurance options. Under current law, these contracts do not have to be reported to the government or any central agency. As a result, this led to a large accumulation of debt during the bubble period that went mostly unnoticed by regulators.

One of the most popular derivative products has been OTC "credit default swaps" (CDSes). These contracts, privately negotiated and written by the originating company (thus, "over-the-counter"), are insurance policies on a bond or mortgage security. One of the main reasons that AIG failed is because it wrote more CDSes than it could cover when the market turned, never believing that there would be enough mortgage defaults to wipe it out.[35]

On July 22, the White House sent a draft derivative regulation bill to Congress proposing changes to the current system. The legislation proposes that derivatives be subject to oversight regulation first and foremost by encouraging the standardization of contracts and requiring that they be traded on an open exchange. This would be the first time that government regulators would be given comprehensive power to track and approve these contracts negotiated from firm to firm. The president's bill establishes the Office of Derivative Supervision (ODS) within the Treasury Department, and commissions it to work with the SEC and CFTC to design standard contract forms for firms to use and trade in an open market. The plan also calls for the harmonization of other futures and securities regulations to address CFTC and SEC oversight gaps for derivatives issued within those markets.

Ultimately, this transparency would make it easier for regulators to assess the systemic risk that derivative debt poses to the financial system. For instance, because all CDS contracts would be publicly visible through an open exchange, regulators would be able to factor the high number of credit default swaps a firm like AIG issues and factor that into their capital reserve requirements (to be established through separate legislation). An open exchange for derivatives would also allow anyone in the market to see what the value of certain insurance contracts is at any given moment.

The bill also increases regulation enforcement tools to prevent fraud, manipulation and abuse in the derivative, futures and securities markets, but spreads the roles for enforcement around. SEC Chairman Schapiro has been lobbying Congress to have all derivatives regulatory powers vested in her organization.[36] Though the White House bill vests the majority of oversight power in a new Treasury branch, the SEC and CFTC are also given the right to issue additional rules and regulation for governing derivative contracts.

The proposed bill would establish regulated central counterparties (CCPs) to clear the contracts in the $9.8 billion derivative industry, taking that role from private firms that currently clear trades. These CCPs would work with an electronic trade system that offers timely reporting of derivative trades, thus quickly disseminating the market price and other trade information.

An important aspect of derivatives is the ability for two parties to privately agree to any terms, customizing the contract to meet consumer demand. Contracts can be generally standard insurance exchanges, as many of the AIG credit default swaps were, or uniquely engineered products to fit a specific need. For instance, in the late 1990s, Jersey City created a unique security from pools of collateralized residential tax liens. Investors, buying up millions of this special derivative (and thus the liens), wound up keeping the city from going into bankruptcy because the city was struggling under the weight of unpaid liens.

These kinds of specialized products are difficult to trade on an exchange because they are unique. As a result, there would be significant economic consequences if these kinds of contracts were banned all together and every derivative was forced into a plain vanilla, standardized form. The current White House proposal calls for robust margin requirements and other risk controls for these customized derivatives. While this complication of the customization process would reduce the value of some derivatives, the Administration feels it is an acceptable trade-off for a more comprehensive understanding of the extent of derivative liabilities.

Economic Interest Requirements for Securities Originators

Obama Plan: Requires all securities originators maintain at least a 5% interest in the security.

President Obama's plan makes two significant reform proposals for issuing securities: first, the originators of securities would have to maintain some portion of economic interest in whatever asset they securitize and sell; second, to align the interests of securities originators with their clients, the compensation of brokers, underwriters and others in the securitization process would be linked to the long-term performance of the securitized asset. Originators would have to hold part of any security they issue and would be compensated over the lifetime of the asset, based on performance.[37]

The Administration argues that security originators had little incentive to provide the due diligence necessary to assess the real risk in an underlying asset. The proliferation of subprime mortgage-backed securities demonstrates this. Under the Obama proposal, federal banking agencies like the National Bank Supervisor determine what percentage of liability an originator must maintain and what the rules will be for broker compensation.

Some analysts have suggested that this requirement for firms to maintain some "skin in the game" will not be very effective. Princeton economics professor Hyun Song Shin argues that financial institutions used securitization to take on more risk themselves, not necessarily to sell it to unknowing clients. "This suggests that forcing firms to hold on to some of the securitized debt won't make much if any difference."[38]

The Atlantic's Megan McArdle agrees, also pointing out that the idea has been tried and was unsuccessful, "I'm skeptical that this will change much. The biggest problem with firms like Lehman is that they held onto too much of the toxic waste they were churning out. Nor has a similar regulation saved Spain from an enormous housing bubble, and a correspondingly enormous messy pop." However, even if the required skin in the game doesn't prevent excessive securitization, coupled with other regulations, it may force financial institutions to look closer at their liabilities.

Executive Compensation

Obama Plan: Requires all executive compensation and severance packages be subject to a non-binding vote from shareholders.

Some of the loudest criticism of Wall Street has been directed at executive compensation and bonuses. The Obama administration has named Kenneth Feinberg the nation's first "Special Master of Compensation" to ensure that Wall Street firms are obeying new executive-pay guidelines in the Bailout and Stimulus bills. Multiple pieces of additional legislation have been proposed in Congress over the past six months to further restrict executive compensation packages at firms that have received government rescue funds. One bill that has not yet been passed sought to give the Treasury Department oversight of any salaried position at a bailed out institution.

President Obama is now proposing an executive pay restriction on all financial institutions, whether or not they have received government funds. The rule would require public companies to submit executive compensation packages for a non-binding shareholder vote. A separate, nonbinding shareholder vote on "golden parachute" severance packages would also be required. The white paper says these votes "provide a strong message to management and boards and serve to support a culture of performance, transparency, and accountability in executive compensation."

Because this provision only requires non-binding votes, it has faced limited criticism. Many firms are open with their shareholders and understand that their owners and clients can withdraw support if they feel management is acting inappropriately in any way, including in designing compensation packages. This will also provide more legitimacy for approved executive compensation, taking some fire from those who want to severely limit what Wall Street can pay its leaders.

The House of Representatives passed a bill on July 31, 2009 according to the president's proposal. The bill requires separate, nonbinding shareholder votes on compensation and severance packages. The bill also grants the government authority to restrict compensation packages it deems "threatening" to the financial sector. The SEC is also granted authority to issue requirements that compensation consultants offer independent advice to boards of directors on executive pay. As of this printing, the bill has yet to be considered by the Senate.

D. Increased Regulatory Measures

Capital Requirements

Obama Plan: Makes capital requirements a part of the new tiered risk structure rules, with Tier 1 firms having the highest capital requirements; creates systems to adjust capital requirements and reserve ratios based on economic conditions; redesigns that models calculate risk-based reserve and requirement measurements to include off-balance sheet liabilities and derivative exposure.

A primary cause of the financial crisis was insufficient capital net worth coupled with declining asset values. Critics point to highly leveraged financial institutions—around 56 to 1 at Citigroup—as irresponsible and in need of shorter leashes. The president's reform proposal focuses on risk-based capital requirements.

The objective of capital requirements is to protect depositors, the FDIC insurance pool, and other institutions from the fallout of a bank's investment mistakes. This is comparable to regulating the construction of a skyscraper's foundation so that it will not fall over and destroy any nearby buildings. The White House has proposed that the Treasury Department perform a comprehensive review of capital structures, due by the end of 2009, to determine new rules governing financial foundations. The review would include recommendations for:

- adjusting capital requirements based on trading positions, equity investments, credit exposures, asset-backed and mortgage-backed security liabilities, exposures to off-balance sheet vehicles and derivative exposure;
- how to adjust capital requirements based on economic conditions, keeping more during good times, but loosening standards in downturns; and
- simpler measures for assessing risk associated with leverage.

The Administration wants capital requirements to be applicable to all financial institutions using the tiered structure discussed earlier, with Tier 1 FHCs singled out for special, heightened reserve and other regulatory requirements. The review will also suggest changes to cut down on off-balance sheet accounting practices that are used to avoid capital requirements. Ultimately, no matter what changes are made to capital requirements, there will be a trade-off between minimizing risk and maximizing wealth creation.

Reforming Money Market Mutual Funds

Obama Plan: Allows mutual funds to suspend payouts in extraordinary economic situations; increases liquidity requirements and SEC oversight.

Until the financial crisis took off in September 2008, only one mutual fund had ever dipped below a net asset value of $1.00 per share—commonly referred to as "breaking the buck." But the typically resilient, low-risk investment vehicles were not spared as financial firms took big hits. The Lehman Brothers collapse caused one fund to break the buck, starting a run on nearly all money market mutual funds (MMFs). The Federal Reserve stepped in to stop the run with a $540 billion guarantee of investments, though nerves remained tense for some time.

The overall goal of MMF regulation reform is to provide protection from the potential of runs on mutual funds in the future. The White House proposal encourages the SEC to continue reforming MMFs, focusing on liquidity requirements and credit risk management. The white paper furthermore suggests the President's Working Group on Financial Markets should prepare a report by September 15, 2009 that would suggest fundamental changes to the MMF regulatory structure. Those changes might mean moving away from a stable net asset value for MMFs or requiring mutual funds to obtain access to emergency liquidity facilities in the private sector.

The proposal also suggests allowing mutual funds to suspend payouts from pools of money in extraordinary situations if it protects the interests of shareholders. This could significantly change the ways investors use MMFs. One of the key values of mutual funds is their liquidity. MMFs are an attractive hedge investment today because money can be moved in and out of mutual funds quickly. The risk that funds might be jammed in an economic downturn would impact how investors approach MMFs, though not necessarily negatively. The additional security of a mutual fund investment that would temporarily freeze during a downturn could drive new people to the investment vehicle.

Treasury Oversight of Federal Reserve

Obama Plan: Allows the Fed to lend to financial institutions in extreme economic conditions with written permission from the Treasury Department.

While the president's regulatory reform plan grants increased authority to the Federal Reserve, it does add a check on its power to lend. The Federal Reserve Act authorizes the Fed to lend to individuals, partnerships and corporations in "unusual and exigent circumstances" with the vote of at least five board members. The Fed must offer evidence that the borrower cannot gain access to capital from the private sector on its own.

Traditionally, the Fed has only used this authority to offer loans to banks, however, in March of 2008, the Fed made the extraordinary move to allow investment banks to request loans. As the financial crisis evolved in 2008 and into 2009, the Federal Reserve broadly defined its "unusual and exigent" authority to extensively lend and inject funds into the financial markets in an attempt to stabilize the recession's effects. By August 2009, the Fed had lent or guaranteed debt totaling nearly $8 trillion.

Many have criticized the Fed as grossly overstepping its authority and abandoning its primary mission as the governor of monetary policy. The White House proposes giving the Treasury oversight of this authority. Under the plan, the Fed Chairman would need to get written approval from the Treasury Secretary before lending under the special authority. However, some believe this would violate the independence of the Fed that is so important, and instead suggest repealing certain powers of the Fed to allow it to focus more strictly on monetary policy.

Expanded SEC Regulation of Credit Rating Agencies

Obama Plan: Expands SEC oversight of credit rating agencies, and requires rating agencies to public disclose the meanings of their ratings in simple terms for consumers to understand.

During the creation of the housing bubble and financial crisis, investors became increasingly reliant on credit rating agencies to research the value of financial products and assets instead of performing their own due diligence. The failure of the credit rating agencies to appropriately asses the risk of subprime mortgages' infiltration of the market has left them as one of the more vilified culprits in the crisis.

The White House plan calls for increasing regulation of the credit rating agencies. Expanding the power of the SEC's governance over credit rating agencies, the proposal would increase and standardize disclosure practices from the agencies to promote integrity of the process. The SEC would govern against conflicts of interest between the agencies and the institutions and products that they rate. Rating agencies would also be forced to publicly disclose exactly what risks their ratings are designed to assess in simple language.

Congressional Republicans put forth an alternate idea to this in July. Under their plan, instead of increasing federal involvement, the government would completely end its relationship with the rating agencies. U.S. law frequently refers to credit ratings as a tool for setting capital requirements, restricting investments and guiding the use of taxpayer money in the marketplace. However, this has reduced the need for money managers to perform proper due diligence. This has also created an oligopoly among the three major agencies. American Enterprise Institute scholar John Makin wrote in a July 2009 paper:

> *The designers of derivative securities effectively collaborated with the rating agencies, such as Standard & Poor's and Moody's, that were relied upon (often through government mandate) by pension funds and other gigantic repositories of wealth with identifying the securities safe enough to invest in.*[39]

The argument of Makin, congressional Republicans and others is that the current state of credit rating agencies already creates too much institutionalization. The GOP plan eliminates all references to credit rating agencies in federal law and seeks to open the rating business up to more competition that will drive an increase in service quality and accuracy.

Reform of Government-Sponsored Enterprises

Obama Plan: Requires Treasury and HUD to develop a plan for reforming GSEs, but does not offer suggestions for how they should be overhauled.

The government-sponsored enterprises (GSEs) Fannie Mae, Freddie Mac and other federal home loan banks played a central role in creating the housing bubble. These organizations, at the prodding of the Bush administration and members of Congress encouraged the GSEs to expand the use of subprime mortgages to help more low-income families become homeowners. The eventual collapse of Fannie and Freddie was a key trigger for the rapid decline in economic stability in September 2008.

The Obama administration has proposed a joint project between the Treasury Department and the Department of Housing and Urban Development (HUD) to research ideas for reforming the GSEs and present recommendations for a series of initiatives to correct problems with the organizations. The White House overhaul plan suggests the series of recommendations should be delivered with the president's 2011 budget.

House Republicans have already developed a plan for dealing with the GSEs. Under the GOP's overhaul plan all GSEs would be shifted from their nationalized condition back to quasi-private management within two years. After that, the Republicans lay out a 13-year timetable for privatizing the assets of the GSEs and ending their federal charter. Some have criticized this plan as taking too long.

International Cooperation

Obama Plan: Commits to work with other nations to coordinate reforms for Basel II requirements, international bank oversight, executive compensation and derivatives; extends information sharing agreements between central banks and regulators; suggests expanding the tiered risk structure to foreign banks.

A main policy point of the Administration's reform proposal is to raise international regulatory standards. The plan makes suggestions for international banking that would bring the world in alignment with other proposals it has made for the domestic market. The white paper recommends increased coordination of international bank oversight, improving Basel II capital reserve ratios, extending information-sharing arrangements between regulators, determining how to apply the tiered risk structure to foreign banks, introducing better compensation practices and matching U.S. derivative regulations.

Because the global financial markets are so interconnected, regulations in one country often impact other countries. This effect can be positive, but not always. If other nations do not adopt similar practices to those of the United States and instead offer more lax regulatory regimes, then regulatory reform may push some financial institutions off U.S. shores to better business opportunities elsewhere.

Part 5

Reason's Criticisms and Suggestions

A. How the Proposal ITurns Tier 1 Financial Institutions Into Government-Sponsored Enterprises

Overall, President Obama's reform proposal falls short of addressing one of the most important problems with the current regulatory system: private sector dependency on taxpayers in the case of failure; the policy of too big to fail.

The central plank of the regulatory proposal is the "Council" of top regulators tasked with detecting systemic risks. Such a Council would have significant sway on financial markets, even without authority through the Fed to take any action. If the Council announced that there was a particular systemic risk, Wall Street would react swiftly, likely with massive selloffs of a company in the Council crosshairs. This kind of soft power would give the Council immense behind-the-scenes influence.

In addition to the Council governing systemic risk, the White House proposal would create a resolution authority for all Tier 1 level financial institutions. Working closely with the Council, this resolution authority would have the power to seize and take apart non-bank financial institutions—including investment banks and insurance groups like AIG—if those firms posed a systemic risk.

Beyond problems with these two ideas individually, when the Council and bankruptcy insurance fund are combined with Tier 1 designation, the result is actually a formalized too-big-to-fail structure that encourages financial institutions to take on more risk knowing they have taxpayer protection. The structure is implicit, but is very much there.

Tier 1 regulatory status tacitly identifies a financial institution that is deemed too interconnected with the financial system to fail. By bracketing off a certain segment of the market, regulators can hold bigger institutions to higher standards, but in doing so they create an elite class that will take advantage of its new status. Coupled with a safety net, the Tier 1 investment banks and financial product specialists will know that any major losses will be absorbed by the—likely taxpayer-funded—resolution authority. While the resolution authority would be unpleasant, there is no indication that the takeover of those firms would be any different than the nationalization of Fannie Mae and Freddie Mac, both of whom are still operating and growing. This means the special class of Tier 1 firms could operate with an implicit bailout guarantee.

Once firms are explicitly deemed too big to fail, it will significantly change their business operations. Having guaranteed bailouts will essentially make Tier 1 firms the best credit risk in the market. Like investors' perception of Fannie Mae and Freddie Mac before their collapse, Tier 1 too-big-to-fail firms will be seen as just as safe an investment as the United States government. The Tier 1 firms will then have access to very cheap credit, like the government and GSEs, giving them a competitive advantage over other firms not quite big enough to be a risk to the market.

Some may argue that this is inevitable, that we can't let interconnected companies fail, and that this is a necessary part of regulation. But the whole notion of special privileges created by regulation, like access to cheap credit, strikes at the core of what regulation is supposed to prevent. The goal of regulation is to provide a framework for fair competition. Firms cannot compete on even ground if the regulatory framework gives some institutions an advantage over others.

The access to cheap credit, and ability to take risks knowing there is a safety net, are guaranteed to distort the operations practices of financial institutions. Recently, small business lender CIT Group, the largest loan originator for local businesses in the country, was denied a bailout from Washington while it sat on the edge of bankruptcy. The government decided that the failure of CIT would not cause much systemic damage to the market. Ultimately CIT was saved by the private sector, but in the wake of the small business lender's crisis, many suggested that if CIT had taken on just a little more risk, it could have grown big enough to qualify for a bailout as too big to fail. While some firms may limit their own risk in order to avoid tougher Tier 1 regulations, there is a very real possibility that the institutionalized bailouts will create perverse incentives for higher risk-taking.

As Congress weighs the regulatory proposals from the White House and others, it must pay careful attention to the unintended consequences of otherwise noble ideas. A good first step would be to ensure that any systemic risk oversight authority has no teeth or soft power. A second way to avoid the problem of regulation creating new GSEs all over the financial sector would be to make the resolution authority's process painful enough, with enough disincentives for company executives that the safety net is avoided at all costs and only exists for the extreme scenario.

The days of gentle Fannie- and Freddie-like bailouts must be over. Ultimately, members of Congress must keep in mind that regulation, first and foremost, is supposed to provide a framework to foster competition. Companies and their operators must not be allowed to take risks with taxpayer money, and there must be some skin in the game for everyone.

B. Suggestions for Congressional Review

President Obama anchored his regulatory overhaul plan to the concept of establishing clear guidelines for the financial sector and getting rid of the current complexity. While several aspects of the financial sector would be consolidated under the proposed plan, it does not make regulation simpler and in many cases discourages competition, adding new layers of bureaucracy and compliance costs.

This all means less time spent investing and creating wealth and more time navigating increasingly complex rules. David Hirschmann at the Chamber of Commerce says “the proposal simply adds to the layering of the system without addressing the underlying and fundamental problems. We can't simply insert new regulatory agencies and hope that we've covered our bases.”[40]

Here are some suggestions for Congress to consider in designing a regulatory process that disentangles the government from the financial sector and adds to a framework for competition:

- **Resilience Focus:** Focus on aspects of regulation that make the financial sector more resilient during the next economic downturn, like incentivizing firms to bear the responsibility for their own risks, instead of depending on anticipation of every foreseeable problem. Financial institutions should be competing to be the safest and soundest firm in the market, not building up portfolios of risk to be Tier 1 bailout-eligible.
- **Systemic Risk:** Design the Financial Services Oversight Council as an informal committee that watches for systemic risk, but works with regulation agencies and makes policy suggestions behind closed doors to avoid affecting market activity.
- **Bank Supervision:** Consolidate the overlapping banking regulations into a national bank supervising agency to simplify the rules, but don’t separate it from consumer protection, a complementary power of oversight. Also, ensure the NBS does not try to force one-size-fits-all regulations on the various types of federal charters within its oversight.
- **Consumer Protection:** Instead of a Consumer Financial Protection Agency, bolster the current consumer protection laws and recognize that people will make financial mistakes even when contracts are clear. Protection reform can come through empowering the current regulators to resolve disputes more easily and collect restitution when necessary. We don’t need an agency with independent power to restrict products it deems harmful; instead, let consumers make choices for themselves. Consumer protection should also be coupled with banking oversight.
- **Bankruptcy vs. Resolution:** Use bankruptcy laws, well developed over the past several decades, to wind down insolvent financial institutions instead of an unfunded resolution authority. If necessary, Treasury could be granted authority to step into non-banks and force them into chapter 14 bankruptcy if their insolvency was imminent, similar to authority over banking institutions.
- **Hedge Funds:** Only require the largest, highly leveraged hedge funds to register with the SEC, and hedge fund operations that are subsidiaries of financial conglomerates.
- **Derivatives:** Ensure that an open derivative exchange does not reduce the potential for customized, unique financial products to be developed.
- **Securities Economic Interest:** Recognize that even requiring originators to have skin in the game by making them keep some financial interest in securities will not eliminate the potential for failure.
- **Capital Requirements:** Don’t depend on capital requirements or reserve ratios to guide financial institution risk assessment, but rather make sure those firms understand the painful consequences of failure, and be prepared to let them fail.

- **Mutual Funds:** Let money market mutual funds establish their own, internal rules for avoiding bank runs and let those policies be a competitive advantage; some firms will have higher capital reserves, with a lower yield, but be safer in an economic storm, while others will be higher risk MMFs.
- **Credit Rating Agencies:** Don't allow for the continued existence of a rating cartel. Eliminate all references to rating agencies from U.S. law and ensure expanded competition over the provision of rating services.
- **Government-Sponsored Enterprises:** Quickly work to privatize the GSEs and end government policies encouraging homeownership growth as they have historically interfered with proper growth in the housing market. The ideal plan would wind down the GSEs by the time the stimulus and bailout programs are ended over the next 18 months.
- **Historical Perspective:** Understand that deregulation did not cause the financial crisis, and don't pile on new rules just for the sake of increasing quantity. The mere creation of new agencies does not reveal future economic conditions any more clearly.

C. Conclusion

Getting regulation right is hard work. Unfortunately, the president's plan does not succeed in adequately addressing the issue of private sector dependence on the government. The institutionalization of bailouts would put significant amounts of taxpayer money unnecessarily at risk and inappropriately influence the risk assessment process at financial institutions.

The White House proposal depends too heavily on anticipating every future risk to the financial sector. The Administration is overly confident in the power of regulators to collect and analyze information from financial institutions. It simply is impossible for the government, or any private firm, to have complete knowledge of the currents of the financial markets.

However, there are some positives. Consolidating federal banking regulation into a National Bank Supervisor would be helpful, as long as consumer protection regulations were brought along as well. Requiring security originators to maintain an economic stake could be an effective way of aligning institution and investor interests, though it may only make marginal changes in behavior.

Ultimately, when designing new regulations and guidelines for the financial services sector, lawmakers want to make sure they do not create conditions for the next crisis. Although many financial sector regulations are out of date and problematic, the restructuring process could cause even more damage if it is not done properly. This means using restraint, not overreacting, and considering the vast potential unintended consequences of any action. Regulations should also avoid, as much as possible, limiting the wealth creation process.

The best regulation comes through a gradual improvement process over years of experience, focusing on facilitating competition and keeping financial institutions accountable for their own risk. This is the fastest way to recovery, with a fully functioning, vibrant financial market that is driving growth in every sector of the American economy.

About the Author

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Related Reason Foundation Studies

Storming Wall Street: A Comparison of the Two Plans to Overhaul Financial Services Regulation in the 21st Century, Policy Brief 81, by Anthony Randazzo

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Avoiding American Lost Decade: Lessons from Japan's Bubble and Recession, Policy Study 373, by Anthony Randazzo, Michael Flynn and Adam Summers

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