



Congressional Oversight Panel

January 2009

SPECIAL REPORT ON REGULATORY REFORM

Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability*

*Submitted under Section 125(b)(2) of Title I of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343

I. Executive Summary

1. Lessons from the Past

Financial crises are not new. As early as 1792, during the presidency of George Washington, the nation suffered a severe panic that froze credit and nearly brought the young economy to its knees. Over the next 140 years, financial crises struck on a regular basis—in 1797, 1819, 1837, 1857, 1873, 1893–96, 1907, and 1929–33—roughly every fifteen to twenty years.

But as the United States emerged from the Great Depression, something remarkable happened: the crises stopped. New financial regulation—including federal deposit insurance, securities regulation, and banking supervision—effectively protected the system from devastating outbreaks. Economic growth returned, but recurrent financial crises did not. In time, a financial crisis was seen as a ghost of the past.

After fifty years without a financial crisis—the longest such stretch in the nation’s history—financial firms and policy makers began to see regulation as a barrier to efficient functioning of the capital markets rather than a necessary precondition for success.

This change in attitude had unfortunate consequences. As financial markets grew and globalized, often with breathtaking speed, the U.S. regulatory system could have benefited from smart changes. But deregulation and the growth of unregulated, parallel shadow markets were accompanied by the nearly unrestricted marketing of increasingly complex consumer financial products that multiplied risk at every stratum of the economy, from the family level to the global level. The result proved disastrous. The first warning followed deregulation of the thrifts, when the country suffered the savings and loan crisis in the 1980s. A second warning came in 1998 when a crisis was only narrowly averted following the failure of a large unregulated hedge fund. The near financial panic of 2002, brought on by corporate accounting and governance failures, sounded a third warning.

The United States now faces its worst financial crisis since the Great Depression. It is critical that the lessons of that crisis be studied to restore a proper balance between free markets and the regulatory framework necessary to ensure the operation of those markets to protect the economy, honest market participants, and the public.

2. Shortcomings of the Present

The current crisis should come as no surprise. The present regulatory system has failed to effectively manage risk, require sufficient transparency, and ensure fair dealings.

Financial markets are inherently volatile and prone to extremes. The government has a critical role to play in helping to manage both public and private risk. Without clear and effective rules in place, productive financial activity can degenerate into unproductive gambling, while sophisticated financial transactions, as well as more ordinary consumer credit transactions, can give way to swindles and fraud.

A well-regulated financial system serves a key public purpose: if it has the power and if its leaders

have the will to use that power, it channels savings and investment into productive economic activity and helps prevent financial contagion. Like the management of any complex hazard, financial regulation should not rely on a single magic bullet, but instead should employ an array of related measures for managing various elements of risk. The advent of the automobile brought enormous benefits but also considerable risks to drivers, passengers, and pedestrians. The solution was not to prohibit driving, but rather to manage the risks through reasonable speed limits, better road construction, safer sidewalks, required safety devices (seatbelts, airbags, children's car seats, antilock breaks), mandatory automobile insurance, and so on. The same holds true in the financial sector.

In recent years, however, the regulatory system not only failed to manage risk, it also failed to require disclosure of risk through sufficient transparency. American financial markets are profoundly dependent upon transparency. After all, the fundamental risk/reward corollary depends on the ability of market participants to have confidence in their ability to accurately judge risk.

Markets have become opaque in multiple ways. Some markets, such as hedge funds and credit default swaps, provide virtually no information. Even so, disclosure alone does not always provide genuine transparency. Market participants must have useful, relevant information delivered in an appropriate, timely manner. Recent market occurrences involving off-balance-sheet entities and complex financial instruments reveal the lack of transparency resulting from the wrong information disclosed at the wrong time and in the wrong manner. Mortgage documentation suffers from a similar problem, with reams of paper thrust at borrowers at closing, far too late for any borrower to make a well-informed decision. Just as markets and financial products evolve, so too must efforts to provide understanding through genuine transparency.

To compound the problem associated with uncontained and opaque risks, the current regulatory framework has failed to ensure fair dealings. Unfair dealing can be blatant, such as outright deception or fraud, but unfairness can also be much more subtle, as when parties are unfairly matched. Individuals have limited time and expertise to master complex financial dealings. If one party to a transaction has significantly more resources, time, sophistication or experience, other parties are at a fundamental disadvantage. The regulatory system should take appropriate steps to level the playing field.

Unfair dealings affect not only the specific transaction participants, but extend across entire markets, neighborhoods, socioeconomic groups, and whole industries. Even when only a limited number of families in one neighborhood have been the direct victims of a predatory lender, the entire neighborhood and even the larger community will suffer very real consequences from the resulting foreclosures. As those consequences spread, the entire financial system can be affected as well. More importantly, unfairness, or even the perception of unfairness, causes a loss of confidence in the marketplace. It becomes all the more critical for regulators to ensure fairness through meaningful disclosure, consumer protection measures, stronger enforcement, and other measures. Fair dealings provide credibility to businesses and satisfaction to consumers.

In tailoring regulatory responses to these and other problems, the goal should always be to strike a reasonable balance between the costs of regulation and its benefits. Just as speed limits are more stringent on busy city streets than on open highways, financial regulation should be strictest where the threats—especially the threats to other citizens—are greatest, and it should be more moderate

elsewhere.

3. Recommendations for the Future

Modern financial regulation can provide consumers and investors with adequate information for making sound financial decisions and can protect them from being misled or defrauded, especially in complex financial transactions. Better regulation can reduce conflicts of interest and help manage moral hazard, particularly by limiting incentives for excessive risk taking stemming from often implicit government guaranties. By limiting risk taking in key parts of the financial sector, regulation can reduce systemic threats to the broader financial system and the economy as a whole. Ultimately, financial regulation embodies good risk management, transparency, and fairness.

Had regulators given adequate attention to even one of the three key areas of risk management, transparency and fairness, we might have averted the worst aspects of the current crisis.

1. Risk management should have been addressed through better oversight of systemic risks. If companies that are now deemed “too big to fail” had been better regulated, either to diminish their systemic impact or to curtail the risks they took, then these companies could have been allowed to fail or to reorganize without taxpayer bailouts. The creation of any new implicit government guarantee of high-risk business activities could have been avoided.
2. Transparency should have been addressed through better, more accurate credit ratings. If companies issuing high-risk credit instruments had not been able to obtain AAA ratings from the private credit rating agencies, then pension funds, financial institutions, state and local municipalities, and others that relied on those ratings would not have been misled into making dangerous investments.
3. Fairness should have been addressed through better regulation of consumer financial products. If the excesses in mortgage lending had been curbed by even the most minimal consumer protection laws, the loans that were fed into the mortgage backed securities would have been choked off at the source, and there would have been no “toxic assets” to threaten the global economy.

While the current crisis had many causes, it was not unforeseeable. Correcting the mistakes that fueled this crisis is within reach. The challenge now is to develop a new set of rules for a new financial system.

The Panel has identified eight specific areas most urgently in need of reform:

1. Identify and regulate financial institutions that pose systemic risk.
2. Limit excessive leverage in American financial institutions.
3. Increase supervision of the shadow financial system.
4. Create a new system for federal and state regulation of mortgages and other consumer credit products.
5. Create executive pay structures that discourage excessive risk taking.
6. Reform the credit rating system.
7. Make establishing a global financial regulatory floor a U.S. diplomatic priority.
8. Plan for the next crisis.

While these are the most pressing reform recommendations, many other issues merit further study, the results of which the Panel will present in future reports. Despite the magnitude of the task, the central message is clear: through modernized regulation, we can dramatically reduce the risk of crises and swindles while preserving the key benefits of a vibrant financial system

Americans have paid dearly for this latest crisis. Lost jobs, failed businesses, foreclosed homes, and sharply cut retirement savings have touched people all across the country. Now every citizen—even the most prudent—is called on to assume trillions of dollars in liabilities spent to try to repair a broken system. The costs of regulatory failure and the urgency of regulatory reform could not be clearer.