

Congressional Oversight Panel

SEIU

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Modernizing the American Financial Regulatory System:
Recommendations for Improving Oversight, Protecting Consumers,
and Ensuring Stability
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IV. Critical Problems and Recommendations for Improvement

The sweeping nature of the current financial crisis points to the need for a thorough review of financial regulation and, ultimately, for significant regulatory reform. As discussed in part III, financial regulation is particularly necessary to manage risk, facilitate transparency, and ensure fair dealings. The current system has failed on all counts, and as a result, numerous discrete problems have emerged. This report focuses on the following most critical of these problems:

1. Systemic risk is often not identified or regulated until crisis is imminent.
2. Many financial institutions carry dangerous amounts of leverage.
3. The unregulated "shadow financial system" is a source of significant systemic risk.
4. Ineffective regulation of mortgages and other consumer credit products produces unfair, and often abusive, treatment of consumers, but also creates risks for lending institutions and the financial system.
5. Executive pay packages incentivize excessive risk.
6. The credit rating system is ineffective and plagued with conflicts of interest.
7. The globalization of financial markets encourages countries to compete to attract foreign capital by offering increasingly permissive regulatory laws that increase market risk.
8. Participants, observers, and regulators neither predicted nor developed contingency plans to address the current crisis.

This section addresses each problem in turn, and provides recommendations for improvement.

1. Identify and Regulate Financial Institutions that Pose Systemic Risk

Problem with current system: Systemic risk is often not identified or regulated until crisis is imminent.

Action item: Mandate that a new or existing agency or an interagency task force regulate systemic risk within the financial system on an ongoing basis.

Action item: Impose heightened regulatory requirements for systemically significant institutions to reduce the risk of financial crisis.

Action item: Establish a receivership and liquidation process for systemically significant nonbank institutions that is similar to the system for banks.

2. Limit Excessive Leverage in American Financial Institutions

Problem with current system: Excessive leverage carries substantial risks for financial institutions.

Action item: Adopt one or more regulatory options to strengthen risk-based capital and curtail leverage.

3. Modernize Supervision of Shadow Financial System

Problem with current system: The unregulated "shadow financial system" is a source of significant systemic risk.

Action item: Ensure consistency of regulation for instruments currently operating in the shadow financial system.

Action item: Increase transparency in OTC derivatives markets.

4. Create a New System for Federal and State Regulation of Mortgages and other Consumer Credit Products

Problem with current system: Ineffective regulation of mortgages and other consumer credit products has produced unfair, and often abusive, treatment of consumers, which destabilizes both families and the financial institutions that trade in those products.

Action item: Eliminate federal pre-emption of application of state consumer protection laws to national banks.

Action item: Create a single federal regulator for consumer credit products.

5. Create Executive Pay Structures that Discourage Excessive Risk Taking

Problem with current system: Executive pay packages incentivize excessive risk.

Action item: Create tax incentives to encourage long-term-oriented pay packages.

Action item: Encourage financial regulators to guard against asymmetric pay packages in financial institutions, such as options combined with large severance packages.

Action item: Regulators should consider requiring executive pay contracts to provide for claw backs of bonus compensation for executives of failing institutions.

Action item: Encourage corporate governance structures with stronger board and long-term investor oversight of pay packages.

6. Reform the Credit Rating System

Problem with current system: The credit rating system is ineffective and plagued with conflicts of interest.

Action item: Adopt one or more regulatory options to address conflicts of interest and incentives.

Action item: Reform the quasi-public role of NRSRO's and consider creating a Credit Rating Review Board.

7. Make Establishing a Global Financial Regulatory Floor a U.S. Diplomatic Priority

Problem with current system: The globalization of financial markets encourages countries to compete to attract foreign capital by offering increasingly permissive regulatory laws that increase market risk.

Action item: Build alliances with foreign partners to create a global financial regulatory floor.

Action item: Actively participate in international organizations that are designed to strengthen communication and cooperation among national regulators.

8. Plan for the Next Crisis

Problem with current system: Participants, observers, and regulators neither predicted nor developed contingency plans to address the current crisis.

Action item: Create Financial Risk Council of outside experts to report to Congress and regulators on possible looming challenges.

V. Issues Requiring Further Study

There are several important questions regarding financial regulatory reform that are beyond the scope of this Report, and will require further attention.

First, the Panel has identified three highly technical issues relating to the financial regulatory system, and recommends that the relevant regulatory agencies take up specialized review of these questions.

These are:

1. *Accounting rules*: Further study is required to identify needed reforms of the current accounting rules, particularly with connection to systemic risk. Among the issues that should be considered are mark-to-market accounting, mark-to-model accounting, fair-value accounting, issues of procyclicality, accounting for contingent liabilities, and off-balance sheet items.

2. *Securitization*: Further study is required to consider the logic and limits of securitization, and reform options such as requiring issuers to retain a portion of offering, phased compensation based on loan or pool performance, and other requirements.

3. *Short-selling*: In light of recent imposed limits, regulation of short-selling should be further studied and long-term policies should be developed.

Second, the Panel plans to address regulatory architecture more thoroughly in a subsequent report, including the issues of co-regulation, universal banking, regulatory capture, the revolving door problem, bankruptcy and receivership issues involving financial institutions, and the division of regulatory responsibilities.