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Re-regulation of the Financial Markets

The current financial crisis is the consequence of an unsustainable economic model in which abundant, cheap debt—made possible by unsound lending practices and the proliferation of complex, opaque and unregulated financial activities and products—substituted for real wage growth. Financial engineering replaced investment in productive economic activity; securitization severed the link between lenders and borrowers; and weak oversight and deregulation allowed the proliferation of conflicts of interest throughout the economy. The result has been excessive risk-taking and debt-financed asset bubbles.

There is now an urgent need for comprehensive financial re-regulation. Treasury Secretary Paulson began the discussion with his March 2008 Blueprint, which offers useful insights regarding the need for comprehensive regulation focused on investment activities rather than just entities. But the Blueprint is ultimately an outdated and misguided plan to weaken regulation in the name of competitive capital markets and its proposals must not form the starting point for re-regulation.

While the severe worsening of the financial crisis since the Blueprint's release appears to have galvanized support for meaningful re-regulation, there is less consensus about what a new system should look like. In part, this reflects the differing interests of the proponents. But it also reflects the complexity of the task. The purpose of this memo is define what we believe are the core principles that should guide reform and highlight specific objectives and features.

Core Principles of Financial Market Reform

1. Comprehensiveness. Regulation must include all financial products, all entities that issue them and all vehicles that invest in them, as well as the financial intermediaries and rating agencies that facilitate these activities.

2. Transparency. Regulation must restore transparency to financial markets, products and statements, as well as to the regulatory agencies that oversee them. The opaque nature of many recent innovations in financial markets, such as SIVs and CDOs, has made it difficult for readers of financial statements and purchasers of securities to understand exactly what they or their companies hold. Largely unseen trading in derivatives also fueled the inflation of the housing bubble, and aggravated the effects of its collapse, in surprising and unexpected ways.

3. Conflicts of interest. Conflicted entities at the center of the financial crisis include ratings agencies that earned fees from the companies and products they rated, mortgage brokers and originators that earned fees but bore none of the resulting credit risk, and investment banks that created and sold mortgage derivatives. Where eliminating conflicts is not feasible, they should be regulated via disclosure, risk retention requirements and imposition of fiduciary duties. Regulatory agencies also need clear mandates that minimize conflicts and opportunities for regulatory arbitrage.

4. Enforcement/Accountability. Agencies tasked with regulatory enforcement must be given the authority and resources to investigate abuses, correct violations and punish offenders. Reforms must empower long-term investors with tools to hold directors and companies accountable.

5. Long-term incentives. Incentives to maximize short-term profits without regard for risk or long-term performance led to unsound and unsustainable practices by brokers, lenders and underwriters. The carrots and sticks of regulation should encourage long-term investment and reward long-term, sustainable performance.

Specific Objectives & Features of Financial Market Reform

1. Reinvigorate the SEC as the investor's advocate by granting it the resources and powers needed to comprehensively regulate at-risk investment activity. The SEC should have authority to regulate investment banks, hedge funds, private equity funds, structured investment vehicles and sovereign wealth funds; the myriad securities, derivatives, and futures (excluding those based on commodities) in which they invest; and the financial intermediaries and entities that create and rate risk, but do not now bear it. This should include the authority to regulate "the procedures and methodologies" by which the ratings agencies determine ratings, a power the Rating Agency Reform Act of 2006 explicitly prohibits. The SEC should be allowed to retain all the fees it collects to fund its own activities.

2. Implement a financial transactions tax to discourage short-term, speculative trading and provide an independent funding stream to enhance the SEC's independence and support its expanded oversight and enforcement activities. (The UK has a stock transfer tax, as did the US from 1914 to 1966.)

3. Impose fiduciary duties to investors upon credit ratings agencies and financial intermediaries in order to give investors a private right of action. Investors must be empowered to hold accountable a rating agency or financial intermediary that assists in defrauding investors.

4. Address conflicted homebuilder mortgage practices through HUD reforms. First, amend the Real Estate Settlement Procedures Act to prohibit homebuilders from referring buyers to mortgage affiliates. Second, HUD should not reauthorize seller-funded down payment assistance programs. Finally, only allow mortgage companies joint ventured with homebuilders to be approved lenders if they employ an automated, centralized process of appraiser selection that prohibits any communication between appraisers and builders' sales personnel, managers or loan officers.

5. Establish Financial Product Safety Commission to protect against predatory and exploitative financial products. The Commission would review financial products and determine their appropriateness for consumers and possibly more sophisticated investors, as well as their potential to increase systemic risk. Establish default products for consumers within each line (e.g. mortgages, credit cards). Funded by fees from financial institutions seeking to offer products. Agency oversight should involve key stakeholders, including workers, consumers and investors.

6. Consolidate safety and soundness regulation of federally-insured, deposit taking institutions to rationalize oversight and eliminate regulatory arbitrage. A single regulator, independent of the Federal Reserve, may be the best solution to the problem in which insured institutions can shop for their regulator, a practice that has helped erode oversight, perhaps most fatally at the OTS. The safety and soundness regulator must have the power and expertise to ensure adequate capital requirements and implement and oversee effective risk management policies and procedures at regulated banks. .

7. Establish Financial Markets Stability Commission to monitor and ensure the overall stability of the financial system, over and above ensuring the soundness of individual institutions or the smooth functioning of particular capital markets. The Commission would evaluate capital, liquidity and margin practices across financial institutions and their potential impact on stability. The Commission would have the power to regulate any entity as it deems necessary in order to ensure system stability.

8. **Correct pro-cyclical bias of regulation.** Capital requirements need to be modified to reflect the systematic unreliability of asset prices in a bubble. Similarly, mark-to-market accounting, while appropriate where discernible market prices exist, produces absurdities when markets break down and liquidity evaporates.

9. **Create incentive that encourage long-term investing and discourage excessive risk-taking.** For example, empower long-term investors with tools to hold managers and boards accountable (e.g. access to the proxy); require executive pay at federally insured institutions to take into account risk and sustainability of performance (e.g. by not paying bonuses annually, eliminating stock option compensation, and requiring substantial equity holding requirements, as UBS has done); and require asset managers to disclose the performance period for portfolio manager incentive compensation.