SOME THOUGHTS ON THE PROGRESSIVE REFORM OF THE FINANCIAL REGULATORY STRUCTURE

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We are living through a severe capital markets crisis. Though its deep roots lie in the effort to maintain consumer spending while real wages stagnate, its immediate cause is regulatory weakness. That weakness has three dimensions. The first is the substantive weakening of regulatory structures— so that less and less capital markets activity is subject to effective regulation. This turns regulatory coverage into swiss cheese. The second is the failure of nationally based regulators to effectively regulate markets that are global in scope, which leads to the whip sawing of national regulators. The third is the refusal of regulators to use their powers, either because of ideology or regulatory capture—famously in the case of the Federal Reserve's approach to mortgage markets. The first two failures can be addressed through structural change, the third problem, perhaps the most intractable, can only be addressed through political change.

The federal rescue of Bear Stearns and the federal sponsorship of the transaction by which JP Morgan Chase is buying Bear Stearns created a further regulatory crisis. Because that transaction involved the rescue of an investment bank, and in particular an investment bank that had made aggressive risk taking its business strategy, it represented a sort of tear in the fabric of regulatory reality. Federal insurance is supposed to be for commercial banks, which pay insurance premiums and are heavily regulated around safety and soundness issues. Investment banks are supposed to be on their own, and their investors—both their equity investors and their creditors, are supposed to do so at their own risk. The Federal Reserve's discount window is supposed to be open only for member institutions, not for anyone in the economy who might need credit, and collateral for borrowing from the Federal Reserve is supposed to be high quality debt instruments, not subprime mortgage bonds. The Bear Stearns bailout left the distinct impression in its wake that the federal government had become the guarantor of all large capital markets institutions, and with no apparent conditions attached to that guarantee—a position everyone recognized as untenable.

Nonetheless, it appears that Bear Stearns had to be bailed out because of the risk that Bear Stearns collapse would have imperiled major insured institutions. Though very little information is available about exactly what systemic risks were in play in Bear Stearns' collapse, it appears this is because of the breadth and scale of the network of lending provided to hedge funds that were clients of Bear Stearns, combined with the extent of Bear Stearns' credit derivatives business. Behind all of this lies the inadequate regulatory structures put in place to address conflicts between commercial banking and investment banking when the Glass Steagall Act was repealed by the Gramm-Leach-Bliley Act in the late 1990's.

Last week, Secretary of the Treasury Hank Paulsen announced a blueprint for capital markets regulatory reform, aimed, he said, at addressing some of these issues. However, the blueprint turned out to be largely based on a deregulatory wish list that had been developed over the last several years by the financial services industry and the U.S. Chamber of Commerce. Paulsen's report merged that deregulatory agenda with two important positive ideas, that financial regulation should be comprehensive, including hedge funds and other private pools of capital, and two, that it should be organized by activity, not by institutional labels. Combining these ideas with a pre-designed deregulation scheme created a certain tension in the Treasury blueprint, and led to it being roundly rejected by investor, consumer and public interest advocates. But the obvious next step for Congress and a new Administration is to separate the principle of comprehensive, activity-based regulation from the deregulatory agenda, and to develop a regulatory structure that flows from those principles.

Structural underregulation in the financial markets creates a regulatory system that is a kind of swiss cheese—where the regulatory holes gradually get larger. Consider for example investing in an index of stocks. If you sell the individual stocks or pool them in a mutual fund, that activity is regulated by the Securities and Exchange Commission and FINRA. Recently, however, banks have been allowed to do this activity under their bank regulator. However, if you sell a contract to buy this index in the future, that transaction is regulated by the CFTC, generally acknowledged to be a much weaker regulator than the SEC and FINRA. And finally, if you make this investment through a over the counter derivative, the transaction is effectively unregulated. And of course, this example only considers activity within the United States.

What follows is the outline of a possible progressive approach to comprehensive capital market regulation. The assumptions behind the approach are that strong, smart, comprehensive regulation is a key advantage to the United States in attracting capital to our economy. Such an approach will increasingly be demanded as a worldwide standard to safeguard the world economy from systemic credit crises driven by the collapse of underregulated capital markets. Another key assumption is that in our federal system there have been benefits over time in having dual regulation at both the state and federal levels. Dual regulation provides a fail-safe in times of regulatory capture. However dual regulation works best when there is a high universal federal standard, supplemented by state regulation.

This approach begins with four categories of government activity in the capital markets.

First, there is the regulation of at-risk investment activity—capital markets activity where there will be winners and losers and the public interest is protected by a combination of transparency, requiring intermediaries to be subject to fiduciary duties, and in some cases, by suitability requirements for investors. Here the need is for comprehensiveness—the coverage of all securities, derivatives, and futures, and all investment vehicles—hedge funds, private equity funds, and sovereign wealth funds under a strong regulatory regime focused on transparency. There is also a need for stronger asset based capital requirements for these activities.

Second, there is the regulation of the process of investing of insured deposits—monies that are not at risk. These monies are invested by institutions whose activities must be closely watched to avoid moral hazard problems. In case of crisis, these institutions must be rescued and then managed. Here there is a need to bring together all the activity of this kind.

Third, there is regulation aimed at protecting consumers seeking financial products that are fundamentally not acting as investors, but rather as consumers of financial services. This includes credit cards, home mortgage lending, personal banking services, consumer loans such as payday loans, money wiring, and the like. Here, while ensuring transparency is a central function, effective regulation generally includes the substantive protection of consumers against exploitative financial products. Again, consumer protection of this kind needs to be brought together in an agency whose mission is clearly focused.

Fourth, there is the regulation of the money supply and the provision of liquidity. This has been the exclusive function of the Federal Reserve. This function could be combined with safety and soundness regulation, or it could be kept separate.

Much harm has been done by the combination of fragmenting these functions and in some cases, combining them inappropriately. For example, consumer protection and safety and soundness regulation are in natural tension with each other and do not mix well. On the other hand, separating financial futures regulation and securities regulation does not make any sense. The only thing less sensible is the exemption from effective regulation of over the counter derivatives, hedge funds and private equity funds.

This framework leaves certain complexities in its wake. One is insurance, which has historically been subject to state regulation, but which conceptually could be encompassed by a federal financial consumer protection agency. The one thing though not to do with insurance is have it regulated directly by the Treasury Department, as the Paulsen framework proposes.

The second is the problem of how to deal with the regulation of safety and soundness issues in the context of integrated financial institutions. An initial thought in this area would be a joint taskforce of the insured deposit safety and soundness regulator and the capital markets regulator. This function requires the involvement of a regulatory agency with deep capital markets sophistication, as well as the traditional safety and soundness regulatory skill set.

Finally, there is the Bear Stearns problem—the need to save uninsured institutions to avoid a systemic shock. This should be an extraordinary action—requiring perhaps the assent of all four regulatory institutions, and it should bring with it extraordinary consequences. Specifically, if there is to be a bailout, there should effectively be a federal takeover of that institution—it should be clear the equity holders and the executives of such a firm will get nothing, and that there will be procedures in place to ensure the bailout does not become a gift of some sort to an acquiring institution. In cases such as the mortgage crisis, any bailout should have explicit conditions associated with it that go toward resolving the underlying crisis.

Despite the positive concepts embedded within it, the Treasury Department blueprint was a clear signal that the Bush Administration is unlikely to be able to work successfully with Congress on a comprehensive regulatory framework that has strong investor and consumer protections. But investors, consumers and public interest advocates need to work both with Congress and the next Administration to see that the ideas of comprehensive, activity-based financial regulation are implemented against the background of a commitment to a strong regulatory philosophy.