Regulatory Rethink

By SENATOR CHARLES E. SCHUMER, CHAIRMAN OF THE JOINT ECONOMIC COMMITTEE
Published on March 28, 2008 in The Wall Street Journal

The sudden collapse of Bear Stearns was a shock to our financial system, and a wake-up call to anyone who believed our financial house was in good order. Last week we looked into a financial abyss, and the Federal Reserve acted swiftly and appropriately to prevent a potentially much broader failure of the financial system. The Fed's actions appear, at least for the moment, to have provided some much needed breathing room to the markets.

But we are by no means out of the woods when it comes to the long-term health of our financial system, or of our economy more broadly. We need to rethink the regulatory framework that governs our financial system.

Over the past decade, consolidation has become the norm in the financial industry. There are no longer commercial banks, investment banks, broker-dealers, traders and insurers. Instead, there are a number of large financial institutions surrounded by many smaller institutions such as hedge funds and private equity funds. It's as though we have a handful of large financial Jupiters encircled by numerous small asteroids.

Still, the U.S. financial regulatory system is based upon older assumptions of each firm only operating in its own sphere. The federal banking regulators have one set of concerns, the Securites and Exchange Commission has another, the Commodity Futures Trading Commission has a third. Many areas of the financial system, such as derivatives, fall outside of regulatory oversight altogether. Adding further confusion, state attorneys general have gotten into the act, introducing another layer of often conflicting standards.

So even though firms no longer operate in the same old ways, our regulatory system still imagines they do. Commercial banks continue to be supervised closely, and are subject to a host of rules meant to limit systemic risk. But many other financial institutions, including investment banks and hedge funds, are regulated lightly if at all, even though they act in many ways like banks. At the same time, all of these market participants are linked as counterparties in a variety of complex, unregulated transactions.

Recent events have made clear that our reliance on the ability of institutions to manage their own risks, and on our regulators to see the weak points and intervene when necessary, has been too optimistic. The goal of financial regulation is to encourage entrepreneurialism while ensuring the health of the financial system. In the 1980s and 1990s, we seemed to have found that balance. But today, the combination of the creation of a global financial market and a non-stop flow of new financial instruments has outpaced our regulatory system.

Figuring out what changes are required is not something we can do quickly. But it is something we must do as soon as possible. I intend to work closely with Sen. Christopher Dodd and other members of the Banking Committee to start this process. There are six goals as we go forward:

- Focus on controlling systemic risk and ensuring stability. As financial markets have become more global and more complex, even the most sophisticated financial institutions don't always understand the risks their decisions involve. And as the financial system has evolved, the weak points have changed. Above all, we need to ensure that whatever may happen to any individual financial actor, we can be confident that the financial system itself will remain strong and stable.

- *Look closely at unifying and simplifying our regulatory structure, perhaps moving toward a single regulator.* In this era of global markets and global actors, we cannot return to the older model of separate businesses with separate regulators. We must consider whether a more unified financial regulatory system could provide more efficient regulation. In our report on maintaining the competitiveness of our financial sector, Mayor Michael Bloomberg and I suggested we should look closely at the system now in place in the United Kingdom. They have a single strong, effective financial regulator, focused on results and not rules, with the power to act. Such a regulator would likely have called in Bear Stearns managers and told them to improve their capital position long before the crisis arose, thus avoiding the backdoor action the Fed was forced to take.

- *Figure out how to regulate currently unregulated parts of the financial markets and opaque and complex financial instruments.* There are too many vital players in the financial markets who operate beyond the scope of federal regulators, yet have the ability to put the system at risk. If investment banks are able to borrow from the Federal Reserve's discount window, then they must be subject to greater regulatory scrutiny. Similarly, we must create an effective regulatory framework for derivatives transactions, such as credit-default swaps, which have grown into a multitrillion dollar part of the financial system.

- *Recognize that a global financial world requires global solutions.*In this era of global finance, we have international markets but we still have national regulations. The danger is that there is often a rush to the place where regulation is lightest and least effective. For example, one of the difficulties in regulating the derivatives market is the concern that if we do it unilaterally, the business will simply move to London, making the system no safer and causing the loss of many American jobs. It creates a dilemma: We cannot allow ourselves to be pulled downward, but we also cannot ignore what happens elsewhere and its impact on our competitiveness.

- *There must be greater transparency.* We must continue to emphasize transparency among all market participants. The ability of investors, lenders and especially regulators to evaluate the quality of holdings and borrowings is essential for restoring confidence. A perfect example is what happened in the market for mortgage-backed securities. Ratings agencies, paid by the creators of products they were rating, essentially rubber-stamped collateralized debt obligations and collateralized mortgage obligations without providing accurate analysis to potential investors. The SEC ignored the inherent conflicts of interest and the risks that entailed.

- *The Bush administration's hostility to regulation has to end.* We've seen the consequences of this approach in too many places. Look at the housing crisis, where unregulated mortgage brokers and lightly regulated mortgage originators like Countrywide played a major role in creating the current mess. Regulators must regulate and use the authority Congress has already granted them to protect the public interest.

Finding a proper regulatory regime suited to today's complex, globalized financial world will not be easy. But it is the only way to restore confidence and ensure that our financial markets are once again the envy of the world.