Reforming Financial Regulation

A Memo to President-elect Obama

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[W]e need to streamline a framework of overlapping and competing regulatory agencies. Reshuffling bureaucracies should not be an end in itself. But the large, complex institutions that dominate the financial landscape do not fit into categories created decades ago. Different institutions compete in multiple markets—our regulatory system should not pretend otherwise. A streamlined system will provide better oversight, and be less costly for regulated institutions.

—Barack Obama, Cooper Union speech, March 27, 2008

Much of our regulatory apparatus was invented in the 1930s…. [O]ur existing patchwork of federal and state regulation is not sufficient to provide the rules of the road in a 21st century economy.

—Obama ’08, “Barack Obama’s Plan to Restore Confidence in the Markets, Tackle the Housing Crisis and Help Protect Families from the Economic Slowdown”

PRESIDENT-ELECT OBAMA, during the campaign, you recognized the need to update America’s outdated regulatory framework to meet the needs of the 21st century. You laid out principles for a revised regulatory system, specifically criticizing the “balkanized framework of overlapping and competing regulatory agencies,” and called for a “more streamlined system of oversight.” You also noted that “details of these changes should be developed only after adequate analysis and public debate.”
Adhering to the following guidelines can help you and your Administration create a financial regulatory system that meets the needs of the 21st century.

- **Don’t stifle the innovation and financial creativity that have made U.S. financial markets world leaders.**
  All too often, regulators see their jobs as making sure that the firms that they oversee and their products fit in carefully defined categories. This leads to both stagnation and higher costs for consumers. While it is tempting after the events of the last year to consider forcing the entire financial industry into one regulatory framework complete with strict rules designed to reduce or eliminate the risk from new products, this would be a huge mistake. The new financial services regulatory system should make encouraging innovation a specific priority.

  Consumers benefit from innovative products that reduce costs and expand the number and types of people who can access financial services. While it is true that many of the “at risk” mortgages were of new types that did not exist in the past, the problems exist more from failure to follow proper underwriting standards than from the products themselves. When proper loan standards are met, these products have enabled millions of Americans to afford to own their own homes. The same is true for many credit card products and investment vehicles.

  Finally, the Madoff scandal was caused by activities that were criminal decades before the first hedge fund. It is a serious error to equate the financial vehicle with illegal activities.

- **Replace rules-based regulation with regulation based on standards.** There is no such thing as a perfect financial regulatory system that will eliminate all risk to companies, consumers, and countries. Moreover, an attempt to create one through a series of overly specific regulations would only end up damaging the national economy and temporarily stifling the industry.

  This approach should be avoided at all costs. Today’s financial regulatory system is based on specific rules that define whether an activity is legal or not. While most of those rules do an adequate job of protecting the stability of the financial system and the interests of the public, many do not. In a dynamic market, it is very easy for financial, legal, and accounting experts to devise ways to circumvent specific rules. By the time rules have been adjusted, it is too late.

  All too often, Congress reacts to a situation by writing even stricter rules that only serve to damage the industry, raise costs for consumers, and drive good jobs overseas. Rather than attempting such an approach, the new financial regulatory system should be based on standards that financial firms would have to meet. Firms would have choices about how to meet their responsibilities, and the standards would be flexible enough to allow regulators to step in quickly when it is necessary.

  Banning specific products or attempting to force all types of financial firms to meet one set of standards will only drive more financial jobs to other locations. If there is a demand for specific products and services, that demand can be met just as easily by companies located outside of the U.S. as by those in New York or Chicago. Instead of banning products or trying to straitjacket the industry, your new financial regulatory system should focus on how to ensure that products and services are provided at acceptable risk levels with appropriate disclosures to both individual investors and entities that monitor systemic risk.

- **Reduce the number of regulatory agencies and rationalize their jurisdiction.** As you have noted, today’s fragmented financial regulatory system is a product of the 1930s. It reflects a financial industry that no longer exists. There is no longer any reason to have four separate agencies regulating banks or three agencies regulating securities exchanges. Today’s system

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3. Ibid.
lacks clear lines of responsibility. The past several decades have seen a remarkable consolidation of entities providing financial services, and the recent market crisis has accelerated that trend.

Government regulatory categories and jurisdictions need to correspond to these changes in the real financial economy. Most of the entities and distinctions born of the economic crisis of the 1930s no longer have relevance today. Crafting an appropriate response to the first major economic crisis of the 21st century with 70-year-old definitions and tools will be impossible.

Instead, you should consider replacing the current system with a streamlined agency or agencies with clear lines of jurisdiction. It would be appropriate to allow one agency to oversee the systemic risk to the financial services industry while another oversees the business side of the industry and a third deals with consumer issues. Other organizational structures could be equally appropriate. However, past efforts to reform financial regulators have broken down as a result of institutional jealousies between regulatory agencies and specific types of financial entities. Rather than tinkering, it would be far better to sweep the old structures away and replace them with new entities.

Similarly, divided congressional committee jurisdiction presents a barrier to comprehensive reform of regulatory roles and jurisdictions. The Agriculture Committees, for instance, have already begun insisting on maintaining or expanding their jurisdiction over the Commodity Futures Trading Commission, despite real-world changes that have moved futures markets far from their agricultural roots and increasingly into financial products. A comprehensive reform should also place the congressional jurisdiction over financial services under one committee.

- Define and implement a clear TARP exit strategy.
  You should charge officials in charge of the Troubled Assets Relief Program (TARP) to begin immediately to plan for the orderly withdrawal of government support from those institutions that no longer need it and for the orderly sale or disposition of assets acquired. They should also plan for the closure of the various credit facilities instituted by the Federal Reserve at the earliest possible time. Such steps may include creation of a Resolution Trust Corporation–type agency like the one used to liquidate the assets of savings and loans in the early 1990s to manage and sell mortgage-related and other assets acquired through the TARP program and the various Fed programs.

- Ensure that American national interests are protected. The recent financial turmoil has led a number of international leaders to propose the creation of an international regulatory system that would impose common rules on all financial institutions. While there is a good case for coordinating national regulatory systems, it would be a huge mistake for the U.S. essentially to cede control of our industry to others.

  The statements of leaders from the European Union and various other nations make it clear that they see an international regulator as a way to control American financial institutions. This was illustrated most dramatically by an EU proposal to require that all securities sold in the EU be rated by a credit rating agency physically located in the EU, even if the financial instruments are actually issued in another area.

  An international system of independent national regulators that use common terminology and have similar standards is appropriate. However, American national interests should never take second place to an international regulator.

**Conclusion**

Financial experts have warned for several decades that the current U.S. financial regulatory system is fragmented and inadequate. Rather than prevent problems, the current system has exacerbated them in many ways. The events of the past several months show that reforming that system cannot be put off any longer. However, it would only make matters worse to replace it with draconian attempts to
micromanage the financial services industry. That approach would both harm consumers and send high-paying jobs overseas.

The new financial regulatory system must have clear lines of responsibility and allow the industry to continue to innovate. It must be flexible enough to adapt to new realities in the global marketplace quickly while still ensuring that our national interests are protected.

The financial services industry has played an essential role in creating prosperity. An appropriate regulatory system will allow it to continue to play that role in the future.

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