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As in the Past, Reform Will Follow Crisis

Historically, crises have led to significant legislation. For example, the panic of 1907 led to the Federal Reserve Act of 1913, which established the Federal Reserve as the central bank. Out of the Great Depression came the Glass-Steagall Act, which established the Federal Deposit Insurance Corp. and separated commercial from investment banking. The thrift crisis in the late 1980s led to the enactment of the Federal Deposit Insurance Corp. Improvement Act (FDICIA) of 1991, which mandated prompt resolution of failing banks and new standards for bank supervision, regulation and capital requirements. The collapse of Enron and WorldCom gave rise to Sarbanes-Oxley in 2002, in an effort to improve the accuracy and reliability of corporate disclosures.[1]

The current financial crisis will undoubtedly spur further regulation. Successful regulation should be aimed not at preventing all failures, but rather at establishing a clear and credible process such that if a failure were to occur, it would take place in an orderly fashion and not cause industry-wide panic.

Portions of the regulatory system currently in place work well. Smaller-bank regulation, for example, was successful during the thrift crisis and during the current crisis. Key components of small-bank regulation are deposit insurance—which assures depositors that they will not lose their money—and prudential regulation —which prevents bankers from abusing deposit insurance. Good monitoring and rating systems are in place, allowing regulators to identify, in a timely way, banks that are on the verge of failing and to prepare for those failures accordingly. Should a bank fail, there are clear rules and organized procedures in place; everyone knows and understands what these rules and procedures are.

A similar system is not in place for large bank and nonbank financial institutions. Large institutions are much more complex and difficult to monitor. Many, if not all, of these institutions are global enterprises.

Assessing the financial well-being of the organization as a whole is challenging, especially because no regulator is responsible for monitoring the entire entity. This can lead to the sudden revelation of problems and, consequently, market disruption.

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Just as an effective monitoring system is needed for these large banks and nonbanks, so is a clear and credible resolution regime. One possibility is to incorporate special considerations for financial institutions into the bankruptcy code, clarifying the process and accelerating it. Quick and clear resolution would avoid market disruptions.[2]

As the need for reform in the financial services industry has been debated, there has been talk about creating a systemic risk regulator. The Fed has long been playing this role on a de facto basis, given that it is the lender of last resort and controls monetary policy. The Fed also has a long history of bringing suspected risk issues to the forefront. My predecessor, Bill Poole, sounded the alarm on Fannie Mae and Freddie Mac in this space nearly seven years ago.[3] The late Fed Gov. Ned Gramlich took his case against predatory lending to Alan Greenspan in 2000. Minneapolis Fed President Gary Stern has been leading the charge against "too big to fail" for years.

Whether a new systemic regulator is needed, along with who would fill that role, is one of just many regulatory issues that need to be decided. So far, the discussion has been broad. Now, it's time to narrow the focus and act.

ENDNOTES

1 See the FDIC's web site for a compilation of banking legislation since the 1880s. Go to www.fdic.gov/regulations/laws/important/index.html.
2 See "Insolvency of Systemically Significant Companies: Bankruptcy vs. Conservatorship/Receivership," Congressional Research Service Report for Congress R40530, April 20, 2009. See http://opencrs.com/document/R40530/.
3 Federal Reserve Bank of St. Louis *The Regional Economist*, October 2002, Vol. 10, No. 4, p. 3.