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The Long and Winding Road to Regulatory Reform

Congress has taken steps to reform our financial system, a difficult and complex task. As of this writing, only the first steps have been taken: Initial legislation has yet to be finalized, and more reforms are needed if we are to prevent future crises.

At the top of my list of additional reforms is an overhaul of Fannie Mae and Freddie Mac, the government-sponsored enterprises that were at the center of the recent crisis. Their actions severely damaged the mortgage market, forced both institutions into conservatorship and will require ongoing large bailouts with taxpayer funds. At a minimum, we need to break up these GSEs—perhaps into regional companies—to open up the market to private players and restructure the incentives under which they operate. Legislators have promised to deal with the GSE problems later this year.

Next, we need to find a way to prevent runs on major nonbank financial institutions, the so-called shadow banking sector. Before the crisis, regulators were not concerned with the possibility of such runs. The more familiar type of run—bank runs by depositors—has occurred numerous times in our economic history, but deposit insurance has successfully thwarted such panics since it was introduced in the 1930s. No one thought that secured creditors of companies such as Bear Stearns, AIG and GMAC would abruptly abandon their repurchase agreements, threatening not only the viability of these companies but also the stability of global financial markets. Deposit insurance is not effective here since these firms do not take deposits. Stricter capital requirements have been proposed as a backstop against excessive risk-taking in the future, but capital requirements alone will not prevent runs.

Extremely large, globally interconnected financial firms are also part of the "too big to fail" conundrum. I can understand the opposition to bailing out these companies. But if we allow abrupt failure, panic will likely ensue, costing society more than would almost any bailout. We need to find a way to unwind these companies in an orderly fashion, similar to the way troubled smaller banks are now quickly and quietly taken over. The proposed legislation does set up a liquidation facility for large financial firms. That facility will probably not gain credibility until it is actually used—until then, we likely have to live with "too big to fail."

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Another segment of the financial system that needs an overhaul is the credit rating agencies. These agencies provided investment-grade ratings to portfolios of risky mortgages that later turned out to be worth very little. The ratings inflation was fueled by laws requiring huge institutional investors to buy only highly rated securities. In addition, the agencies depended on income from the very companies whose securities they were being asked to rate. Competition among the raters was severely limited. Clearly, a fresh start is needed here.

Moreover, some of the proposals in the pending legislation remain problematic. For example, I am not convinced that a council of regulators and political appointees can effectively oversee systemic risks. Preventing the recent crisis would have required that such a committee have (i) the insight to recognize the housing bubble five years ago, (ii) the ability to agree on the appropriate course of action and (iii) the authority and fortitude to implement regulatory policies to stabilize the situation. Such actions would have been very unpopular at the time, given public policies aimed at supporting greater home ownership and given that everyone—the mortgage originator, the mortgage investor, the homeowner, home builders and so on—seemed to be benefiting from the boom. The Fed, with an arm's-length separation from daily politics and a long-term view of the economy, may be a better candidate to monitor systemic risk.

The proposal for a new consumer financial protection agency also needs honing. I support the intention of the proposed legislation, but if this agency is going to be housed in the Fed, it needs to be accountable to the Fed. If not, it should stand on its own.

As we continue to reform our financial system, we must keep in mind two additional facts. First, financial markets are global. We will need the cooperation of regulators in other countries if we are to prevent crises. Such cooperation may not come easily. Second, the financial system is not just the banking system. As the recent crisis illustrates, nonbanks—the GSEs, the investment banks, the insurance conglomerates—are as much of a concern, if not more so, than the banks. We must take into account and regulate the entire financial landscape. Success at this task is still far down the road. Ω