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Rebuilding Wall Street:
Suggestions for Reforming Financial Services Regulation

by Anthony Randazzo

Getting regulation right is hard work. Unfortunately, the president's plan does not succeed in adequately addressing the issue of private sector dependence on the government. The institutionalization of bailouts would put significant amounts of taxpayer money unnecessarily at risk and inappropriately influence the risk assessment process at financial institutions.

The White House proposal depends too heavily on anticipating every future risk to the financial sector. The Administration is overly confident in the power of regulators to collect and analyze information from financial institutions. It simply is impossible for the government, or any private firm, to have complete knowledge of the currents of the financial markets.

Ultimately, when designing new regulations and guidelines for the financial services sector, lawmakers want to make sure they do not create conditions for the next crisis. Although many financial sector regulations are out of date and problematic, the restructuring process could cause even more damage if it is not done properly. This means using restraint, not overreacting, and considering the vast potential unintended consequences of any action.

Regulations should also avoid, as much as possible, limiting the wealth creation process. The best regulation comes through a gradual improvement process over years of experience, focusing on facilitating competition and keeping financial institutions accountable for their own risk. This is the fastest way to recovery, with a fully functioning, vibrant financial market that is driving growth in every sector of the American economy.

Here are some suggestions for Congress to consider in designing a regulatory process that disentangles the government from the financial sector and adds to a framework for competition:

- Resilience Focus: Focus on aspects of regulation that make the financial sector more resilient during the next economic downturn, like incentivizing firms to bear the responsibility for their own risks, instead of depending on anticipation of every foreseeable problem. Financial institutions should be competing to be the safest and soundest firm in the market, not building up portfolios of risk to be Tier 1 bailout eligible.

- Systemic Risk: Design the Financial Services Oversight Council as an informal committee that watches for systemic risk, but works with regulation agencies and makes policy suggestions behind closed doors to avoid affecting market activity.
- Bank Supervision: Consolidate the overlapping banking regulations into a national bank supervising agency to simplify the rules, but don't separate it from consumer protection, a complementary power of oversight. Also, ensure the NBS does not try to force one-size-fits-all regulations on the various types of federal charters within its oversight.
- Consumer Protection: Instead of a Consumer Financial Protection Agency, bolster the current consumer protection laws and recognize that people will make financial mistakes even when contracts are clear. Protection reform can come through empowering the current regulators to resolve disputes more easily and collect restitution when necessary. We don't need an agency with independent power to restrict products it deems harmful; instead, let consumers make choices for themselves. Consumer protection should also be coupled with banking oversight.
- Bankruptcy vs. Resolution: Use bankruptcy laws, well developed over the past several decades, to wind down insolvent financial institutions instead of an unfunded resolution authority. If necessary, Treasury could be granted authority to step into non-banks and force them into "chapter 14" bankruptcy if their insolvency was imminent, similar to authority over banking institutions.
- Hedge Funds: Only require the largest, highly leveraged hedge funds to register with the SEC, and hedge fund operations that are subsidiaries of financial conglomerates.
- Derivatives: Ensure that an open derivative exchange does not reduce the potential for customized, unique financial products to be developed.
- Securities Economic Interest: Recognize that even requiring originators to have skin in the game by making them keep some financial interest in securities will not eliminate the potential for failure.
- Capital Requirements: Don't depend on capital requirements or reserve ratios to guide financial institution risk assessment, but rather make sure those firms understand the painful consequences of failure, and be prepared to let them fail.
- Mutual Funds: Let money market mutual funds establish their own, internal rules for avoiding bank runs and let those policies be a competitive advantage; some firms will have higher capital reserves, with a lower yield, but be safer in an economic storm, while others will be higher risk MMFs.
- Credit Rating Agencies: Don't allow for the continued existence of a rating cartel. Eliminate all references to rating agencies from U.S. law and ensure expanded competition over the provision of rating services.
- Government-Sponsored Enterprises: Quickly work to privatize the GSEs and end government policies encouraging homeownership growth as they have historically interfered with proper growth in the housing market. The ideal plan would wind down the GSEs by the time the stimulus and bailout programs are ended over the next 18 months.
- Historical Perspective: Understand that deregulation did not cause the financial crisis, and don't pile on new rules just for the sake of increasing quantity. The mere creation of new agencies does not reveal future economic conditions any more clearly.

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