Americans for Financial Reform
Accountability, Fairness, Security

Restoring Prudential Financial System Regulation

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Essential Information

Background

For the last three decades, financial regulators, Congress and the executive branch have steadily pulled back the regulatory system that restrained the financial sector from acting on its own worst tendencies. The post-Depression regulatory system aimed to force disclosure of publicly relevant financial information; established limits on the use of leverage; drew bright lines between different kinds of financial activity and protected regulated commercial banking from investment bank-style risk taking; enforced meaningful limits on economic concentration, especially in the banking sector; provided meaningful consumer protections (including restrictions on usurious interest rates); and contained the financial sector so that it remained subordinate to the real economy.

This regulatory system was highly imperfect, of course, but it was not the imperfections that led to the system's erosion and collapse. Instead, it was a concerted effort by Wall Street, which gaining momentum steadily until it reached fever pitch in the late 1990s that continued through the first half of 2008.

One of the key flaws in that system was a lack of prudential supervision by the financial regulators themselves. They failed to use their broad powers. Bank regulators were supposed to hold banks to adequate capital standards, prevent unsafe and unsound lending and maintain an adequate deposit insurance base.

With too little congressional oversight, regulators became too cozy with the banks. Worse, the Congress acceded to industry demands to reduce deposit insurance premiums and to even base them on weak "risk" standards. As a result, many banks avoided making adequate payments into the funds even as the level of risk they placed on the system grew. This worsened moral hazard.

Further, the bank regulatory system is largely outside of congressional purview because bank regulators are not paid out of congressional appropriations. Instead, regulators receive dues assessments from banks and control their budgets. In combination with entities' ability to choose their own regulators, this creates a race to the bottom, in which banks seek the least attentive regulator that will grant them the most powers.[1]

[1] Adapted from Rob Weissman & James Donahue, Essential Information & Consumer Education Foundation, *Sold Out: How Wall Street and Washington Betrayed America* (2009) at 14-02.

Recommendations

1. We need a simpler and more transparent financial system that is far less vulnerable to speculative abuse and systemic risk, as well as a reliable policing mechanism in order to restore the financial markets to their proper role as facilitators of the real economy. A core principle of both efforts is that any institution that creates credit (and hence risk) must be subject to prudential regulation. It does not matter whether the institution calls itself a commercial bank, an investment bank, a mortgage broker, a hedge fund or a private equity firm. There must be no category of institution that escapes supervision. As Barack Obama astutely stated in an important campaign speech on March 27, 2008, at Cooper Union in New York: "We need to regulate institutions for what they do, not for what they are."[2]

2. Congress needs to separate dues assessments from regulatory authority to prevent regulatory capture. The number of regulators should be reduced in any event, but the potential for charter shopping must be eliminated. Banks should pay regulatory assessments into a pool. Then, regulators should be required to submit performance and budget requests to the Congress to obtain funds from that pool for regulatory needs. All bank regulators should have their full budgets subject to Congressional oversight.

3. The inconsistencies in regulatory authority that have allowed financial services holding companies to abuse relationships between investment and insured depository banks under their control should be changed.

4. A variety of actions must be taken to improve capital standards, reduce leverage, require "skin in the game" in securitizations, and bring off-balance sheet entities onto balance sheets.

5. Regulators must limit the size of banks through prudential oversight. The deposit insurance system should be reviewed. Imposition of significantly higher premiums on larger banks and other actions to limit the size of larger, more complex financial institutions will hold those firms more accountable for their risks and temper their size. As FDIC Chair Sheila Bair has posited: "A strong case can be made for creating incentives that reduce the size and complexity of financial institutions as being bigger is not necessarily better."

6. Give the FDIC more authority over holding companies. As Bair has testified, "Where previously the holding company served as a source of strength to the insured institution, these entities now often rely on a subsidiary depository institution for funding and liquidity, but carry on many systemically important activities outside of the bank that are managed at a holding company level or non-bank affiliate level."[3] This means that the FDIC needs greater authority over the actions of an entire holding company, not just a failing bank, to limit risk caused by the holding company's actions.

7. Preemptive actions by Federal agencies and the courts restricting state enforcement authority should be reversed to reinstate the ability of state legislators, regulators, and courts to

[2] Adapted from Bob Kuttner, Demos, *Financial Regulation After the Fall* (2009) at 5.
[3] Sheila C. Bair, Chairman, FDIC, "Regulating and Resolving Institutions Considered "'Too Big To Fail,'" before the Committee on Banking, Housing, and Urban Affairs, United States Senate, May 6, 2009.

enforce federal and state laws against nationally regulated institutions and to enact stronger state-level consumer protections.

8. Each prudential regulator should issue an annual report on emerging risks so that the public will know what trends the regulators are observing.

9. The data included in public Call Reports, or statements of condition, of institutions under federal regulation should be broadened and subject to more detailed public disclosure so that the public and the Congress can better evaluate where institutions obtain their income and where their risks are changing over time.

10. Each regulator should also implement an effective complaint system that actually assists consumers and complements the efforts of the Financial Product Safety Commission.