Systemic Risk Regulation

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The current financial crisis is the natural and logical result of a failed financial regulatory system that placed an irrational faith in the ability of markets to self-correct. As a result, regulators ignored repeated warnings about the over-the-counter derivatives markets, problems with securitization and lax mortgage underwriting standards, excessive leverage in financial institutions, and the general movement of financial activity into increasingly complex and opaque forms.

1. Systemic risk is best addressed by strengthening other types of regulation.

The most important step in addressing systemic risk is to ensure the safety and soundness, fairness, transparency, and accountability of financial markets, participants, and products. If regulatory agencies perform those functions properly, then systemic risk will be far less of a problem. Congress must close loopholes in the regulatory structure to ensure that all financial products and activities are subject to appropriate oversight, provide agencies with sufficient resources to fulfill their mandates, and hold them accountable to do so. Finally, regulators must pursue their responsibilities vigorously. Policy makers should not permit the question of a new systemic risk regulator to eclipse the tasks of strengthening other forms of oversight and accountability; nor should they over-assume the existence of systemic risk.

2. A systemic risk regulator could supplement the activities of existing regulators.

In addition to the responsibilities of other regulators, one central authority should be responsible for monitoring and stemming potential systemic risks. An effective systemic risk regulator must identify and cure risks that could threaten the broader financial system, stopping institutions from creating systemic risk by growing to a certain size or complexity, becoming too interconnected, or engaging in certain activities. Regulators also must have resolution authority for non-bank financial institutions to ensure that, should an institution become systemically significant and fail, it can do so in an orderly fashion without undue impact on the broader economy.

The systemic risk regulator must have staff, resources, and expertise sufficient to monitor sources of systemic risk in institutions, products, and activities throughout the financial markets, and it must have the power to act promptly and independently. It also must be fully accountable and transparent to the public.

The current crisis has provided dramatic proof that anti-consumer and anti-investor practices create systemic risks that undermine the financial system and the broader economy. As such, the systemic risk regulator should not have the power to preempt consumer or investor protections based on the false belief, embraced by some safety and soundness regulators, that consumer and investor protections are in tension with the health of financial institutions.

3. Primary authority for systemic risk regulation may be assigned to the Federal Reserve, a new regulatory agency, or a council of regulators.

The Federal Reserve can serve as the systemic risk regulator only if it is made transparent and conflicts of interest inherent in its structure are corrected. Given that the Fed has had primary responsibility for maintaining economic and financial stability to date, some have suggested that the Fed is the most appropriate agency to act as the systemic risk regulator. This proposal raises concerns because of the Fed's failure to mitigate the housing bubble by calling attention to the unsustainable run up in house prices and stemming the flow of deceptive loans that fed the bubble. The proposal also raises concerns because the Fed is not a true public agency; it is deeply non-transparent and has conflicts of interest built into its governance structure. At a minimum, the Fed must be reformed substantially before it could be considered as an appropriate systemic risk regulator, for example by removing bank representatives from the governance of the regional Reserve Banks.

Systemic risk could be regulated by a council composed of the heads of each relevant federal agency and representatives from state agencies. One benefit of the council of regulators is that each brings an understanding of the risks unique to the organizations and activities under his or her supervision. The council would be able to oversee all areas of the financial system with less distraction by industry- or product-specific concerns and with less risk that multiple missions, for example consumer protection and bank solvency, would lead to distraction and cause undesirable outcomes for working families. To be effective, such a council must have the authority to act without the delay of working through some other primary regulator and must have sufficient staff and other resources of its own. It also must be directly accountable for its actions and results.

A new regulatory agency could be created to oversee systemic risk. This idea is championed by those who worry that a regulatory council will prove ineffective and prone to jurisdictional disputes, but who oppose to the Fed.

Regardless of how systemic risk regulation is conducted, it cannot be viewed as substitute for proper regulation and consumer and investor protections. To the contrary, if conducted properly these other forms of oversight can forestall most of the need for systemic risk regulation.