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The Obama Administration's Proposal for Financial Regulatory Reform

Analysis by the Mercatus Center Financial Markets Working Group

The proposed regulatory restructuring is based on a misdiagnosis of the cause of the crisis. There are better ways to address the problems in our financial markets. After several months of anticipation, the Obama administration released its far-reaching proposal to reform the country's financial regulatory structure. At its heart, the proposal assumes the current crisis was caused by gaps in regulatory coverage between agencies while largely ignoring the role of federal policy decisions. As a result, many of the newly proposed policies repeat the mistakes made by past policy and risk unintended consequences.

The Mercatus Center Financial Markets Working Group, a group of 16 university-based scholars, has been working on these issues for the duration of the crisis and scholars are available for consultation as policy makers consider this proposal.

Systemic Risk

- **Margaret Polski** points out that the decentralized nature of systemic risk makes a centralized regulator, like the Fed, ill-suited to monitoring and regulation.

- The proposal's systemic risk council may make sense in theory, but in practice it can be a new source of systemic risk. **Tyler Cowen** notes, the more formal the institution, the greater its power to spook markets and become a source of systemic risk itself. If one day the Council warned that systemic risk was unacceptably high, economic activity could immediately freeze up.

- **Garett Jones** offers "speed bankruptcy" as a straightforward, non-political resolution mechanism to deal with large, interconnected distressed firms. Essentially bond liabilities are converted into equity and the bank is recapitalized. With this solution, the equity holders who should bear the risk take the loss when a firm fails, not taxpayers.

Derivatives

- **Houman Shadab** has shown that the trouble with the credit default swaps that contributed to the crisis was not a result of the instrument, but rather the underlying mortgage-based asset. Most credit derivatives had nothing to do with the crisis and in all likelihood increased overall stability.

- Moreover, by concentrating transactions in one place a derivatives clearinghouse could be a new source of systemic risk. The proposed regulation creates incentives to create non-standardized products purely for regulatory rather than economic reasons, threatening to repeat the mistakes of the past.

- Any new proposal should take into account the significant reform efforts underway between derivatives markets participants and the New York Fed. New regulation could interfere with this cooperative solution and disrupt financial markets even further.

Securitization

- The securitization of credit appeared to play a big part in the financial crisis, and accordingly the proposal seeks to require that originators of such securities retain a financial interest. However this is unlikely to solve the problem because, as **Lawrence J. White** points out, in many instances the originators *did* own significant pieces of the securities they created, which is why they took large losses when the securities fell in value.

- According to **Arnold Kling**, the problem wasn't securitization. Securitization was a response to Basel II capital standards that created an incentive to load up on AAA rated products at the lowest cost. Securitization allowed banks to get large portions of their mortgage portfolios rated AAA, and these ratings in turn lowered capital requirements.

Consumer Financial Protection Agency

- The administration wants a new agency to encourage simpler financial products and limit the type of products offered, while also increasing access. But **Todd Zywicki**'s research demonstrates that these goals are incompatible. Regulations which increase the cost of providing credit will force consumers – especially those who already have few options – to seek even more costly (and risky) forms of credit.

- More generally, **Tyler Cowen** emphasizes that good regulation comes through many years of experience and gradual process improvements, built upon some reasonable methods for imposing regulatory accountability. The highly bureaucratic reorganization of Homeland Security provides a cautionary tale for attempting to reshuffle the authority of several different agencies.

ABOUT THE FINANCIAL MARKETS WORKING GROUP

Drawing upon the Mercatus Center's long-standing expertise in regulatory analysis and research into regulatory outcomes, the Financial Markets Working Group combines academic research on finance and banking with a deep understanding of the regulatory policy process to offer productive ideas to address the serious problems in financial markets.

The goal of the Mercatus Financial Markets Working Group is to serve as a resource to ensure that sound academic research informs the important and significant decisions that are underway concerning our financial system. Scholars are available to discuss their research and new research is released each week.

The research to which these comments refer is available at www.mercatus.org/fmwg.

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