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Why an Independent Financial Markets Commission Is Needed Now

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The current financial crisis has many causes; there is plenty of blame to go around. While immediate action was necessary to stabilize the banking system, policymakers need a better understanding of the roots of the crisis before making permanent changes. Depression-era regulatory structures must be brought in line with a globalized 21st-century economy, but hasty changes could do more harm than good. An Independent Commission on Financial Markets—similar to the 1987 Brady Commission, but chartered by Congress—could provide Congress and the next Administration with the information necessary to make informed decisions about financial regulatory and market restructuring. Appointing a commission now would avoid losing the three months until the next President takes office and allow the commission to work in concert with the newly elected President's transition team.

Three Important Roles of a Financial Market Commission. Public policy commissions can be useful to develop information, overcome structural barriers, and build consensus for politically divisive reforms. A Financial Markets Commission could contribute in all three areas:

1. *Gathering Necessary Information.* Highly integrated global financial markets are poorly understood by the public and many policymakers. Experienced regulators agree that better understanding of such markets is critical to making informed policy choices.

   For instance, as noted by former SEC Chairmen William Donaldson, Arthur Levitt, and David Ruder: "Before we embark on a radical restructuring of the financial regulatory system, we must understand clearly where the current problems lie, what was and was not done by regulators leading up to the current crisis, and whether new powers are needed to keep pace with financial innovation."[1]

   A commission armed with the power to subpoena key players and records could provide a clearer picture of financial markets and identify areas and institutions in need of reform. An independent commission would develop a more accurate picture than that portrayed in the politically charged investigations underway now in Congress.

2. *Breaking Institutional Barriers.* Regulation of banking and financial markets is divided among at least half a dozen agencies whose jurisdiction and authority are defined by historical market segments that no longer exist or are economically irrelevant.[2] Following the 1987 stock market crash, President Reagan appointed the "Brady Commission,"3 a group consisting of five top business leaders, to explore the crash's causes and remedies. The commission's top recommenda-

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tion—the consolidation of financial market regulation—was blocked by interagency disputes.[4]

An executive branch interagency task force is ill-suited to addressing structural regulatory divisions; the very agencies whose jurisdiction or existence need review would be the principal participants. Subsequently, innovative policy is unlikely to emerge from such a group.

Congressional oversight of financial regulation is similarly splintered. At least six committees have major roles in setting policy.[5] Further, Congress itself, by both action and inaction, contributed to conditions creating the current crisis. A commission of sufficient stature and independence could give Congress, as well as the executive branch, the frank advice it may need to make appropriate policy decisions and structural reforms. Such a commission could also help identify basic facts, avoiding the need for factual inquiries by multiple congressional committees.

3. *Reaching Political Consensus.* Some blame "deregulation" for the recent market crisis;[6] others point to government mistakes, such as lax lending fostered by Fannie Mae and Freddie Mac.[7] Excesses by some private companies also played a role. Sorting out the roles and mistakes of government-sponsored enterprises (GSEs), regulators, private companies, and even Congress will not be a simple process. An independent commission would provide the perspective to assess Congress' own role in the crisis, along with other factors, without needing to defend past policy choices. A well-supported report might reduce political posturing and focus policymakers on remedies most likely to improve markets.

The Commission's Charter: Issues That Need to Be Addressed

- *Regulatory Roles and Failures.* A splintered and outdated regulatory system may have blocked rather than promoted market transparency and efficiency. An appropriate regulatory structure is at least as important as specific regulatory standards such as capital and leverage requirements. The commission should address both.
- *Roles of GSEs and Other Government Incentives.* Creation of moral hazard through government incentives and guarantees contributed significantly to the housing bubble. The future of GSEs and of heavy government involvement in the housing finance market should be considered fully.
- *Congressional Intervention.* Well-intentioned proposals to promote home ownership or protect particular institutions also played a role in the housing bubble. One of the greatest services a commission could provide is to give Congress itself an honest assessment of how policy choices contributed to problems in the housing and finance markets.
- *International Coordination.* Financial reforms must take account of the global nature of financial markets. The Basel Committee on Banking

1. William Donaldson, Arthur Levitt, Jr., and David Ruder, "Muzzling the Watchdog," *The New York Times*, April 29, 2008, at *http://www.nytimes.com/2008/04/29/opinion/29levitt.htm?_r=2&oref=slogin&oref=slogin* (October 23, 2008).
2. These include the Treasury Department and its Office of Thrift Supervision, the Federal Reserve and its regional banks, the Office of the Comptroller of Currency, HUD (housing finance), the Securities and Exchange Commission, and the Commodity Futures Trading Commission.
3. Executive Order no. 12614 "Presidential Task Force on Market Mechanisms," November 5, 1987, at *http://www.reagan.utexas.edu/archives/speeches/1987/110587k.htm* (October 23, 2008).
4. The Brady Commission did spur creation of the Working Group on Financial Markets, which has coordinated government action in the current crisis.
5. These include Agriculture (House and Senate), Banking, Finance, Financial Services, and Ways and Means.
6. See James L. Gattuso, "Meltdowns and Myths: Did Deregulation Cause the Financial Crisis?" Heritage Foundation *WebMemo* No. 2109, October 22, 2008, at *http://www.heritage.org/Research/Economy/wm2109.cfm.*
7. See J. D. Foster, Ph.D., David C. John, and Stephen Keen, "Fannie and Freddie: Time to Clean up the Mess and Move Forward," Heritage Foundation *WebMemo* No. 2055, September 9, 2008, at *http://www.heritage.org/Research/Economy/wm2055.cfm.*

Supervision already plays an important role in coordinating and harmonizing financial regulatory standards, along with other international institutions. The commission should consider what reforms to international mechanisms may be beneficial.[8]

- *Role and Regulation of Derivatives.* Credit default swaps and other derivatives caused risks to cascade rather than be hedged in unanticipated market conditions. The swaps market is both globalized and highly decentralized: Most swaps trade over-the-counter rather than on exchanges. The resulting market lacks transparency and stability. There are market solutions—such as exchanges or central clearing—as well as regulatory approaches to improving markets for swaps and other derivatives. A commission with investigative authority could help clarify what problems exist in current markets and recommend appropriate remedies.

Structure of the Commission. To be successful, the commission must be genuinely bipartisan. For instance, allowing two appointments each by the President and House and Senate minority, and three each by the House and Senate majority (with either party consulting the President-elect), would produce a 12-member commission with partisan balance. Members could choose a chairman and vice chairman from among their number. Staff could be drawn from existing federal agencies.

The Commission's Time Frame. The Brady Commission produced a lengthy and useful report in only 60 days. The two and a half months between the election and inauguration provide a similar period in which a commission could study and report on the current crisis. A commission going to work in mid-November could issue an initial report before the next Administration takes office. Legislation should include a means of extending the commission if the new Administration finds additional study useful.

Essential Components of a Commission. In light of the lack of clear understanding of the causes of the current market crisis, hasty legislative changes in the upcoming lame duck session would be ill-advised. The gap between the election and a new Administration presents an opportunity to appoint a commission to aid Congress and the new President in deliberating before legislating. The following proposals would help create such a commission:

- The President should submit a proposal to establish a Financial Markets Commission before the election.
- Congress should approve a commission bill in its lame duck session. Waiting until late January (for the next President) is inexcusable.
- If Congress does not hold a lame duck session, the President should consult with the President-elect and congressional leaders and appoint a commission as part of the transition process.

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8. See Brett D. Schaefer, "Gordon Brown's Financial Folly: The Global Economy Does Not Need More Regulation," Heritage Foundation *WebMemo* No. 2107, October 17, 2008, at *http://www.heritage.org/Research/InternationalOrganizations/wm2107.cfm.*