WebMemo

Published by The Heritage Foundation

No. 2610
September 14, 2009

The Lehman Brothers Collapse: Financial Regulation One Year Later

David C. John

One year ago today Lehman Brothers collapsed, sending another 92 subsidiaries into bankruptcy. President Obama will mark the occasion with an address to Wall Street in which he will likely outline some broad principles for financial regulatory reform. Unfortunately, the blueprint for financial regulatory reform issued by his Administration thus far is a detailed mixture of overreaching policy mistakes, missed chances for real reform, blanks that will be filled in later after studies, and a few good ideas.

Financial regulation is very complex, and even small mistakes can have huge consequences. The President must avoid policies that would add more layers of regulation without making any major changes in the regulatory structure or addressing any of the other serious questions that have arisen since Lehman's failure.

Policy Mistakes to Avoid. The President and Congress should:

- *Avoid making the Federal Reserve serve as systemic risk regulator.* The Obama Administration proposes to put the Federal Reserve Board in charge of regulating systemic risk, but it is not clear how such regulation would work in practice, or even if those approaches are the best ways to address the problem. Charging a single entity with reducing systemic risk is likely to raise false expectations. It is very doubtful that any systemic regulator will be able to successfully fill this role unless it has almost unlimited powers. Such open-ended power, however, would be difficult to constrain and should therefore be resisted.

  If a systemic risk regulator is actually needed, that role should be assigned to the new Financial Services Oversight Council, a grouping of the heads of all of the federal financial regulatory agencies. Systemic risk is far more likely to be successfully contained if there are concerted actions from all of the involved regulators than if it becomes the exclusive responsibility of one agency. However, the regulatory council's power should be limited so that it cannot force financial institutions to come under its supervision without the explicit advance approval of Congress.

- *Do not create a Consumer Financial Protection Agency (CFPA).* The Administration proposes to consolidate existing consumer regulators into a new and very powerful Consumer Financial Protection Agency. This is the single largest policy mistake in its financial regulatory reform plan.

  Creating a CFPA is a superficially attractive way to emphasize the Administration's concern for this area. However, the proposal assumes that consumers are unable to understand any complex financial products—even when they are

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm2610.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

provided with detailed disclosures in advance of purchase. This basic contempt for the intelligence of consumers would extend to requiring them to refuse certain basic products before they would be allowed to purchase anything else.

Instead of actually helping consumers, the proposed CFPA would more likely stifle innovation. Separating the oversight of consumer products from an overall understanding of financial institution operations and financial strengths and weaknesses is likely to result in decisions that decrease the attractiveness of products, causing many that could be attractive to consumers to be withdrawn or offered only to select groups.

In addition, the proposed law does not even set out a single national standard that consumer financial products would have to meet to be acceptable. Instead, it explicitly encourages states to define stricter standards that would substitute for the federal ones. National firms could face up to 51 separate consumer regulatory regimes, complete with disputes about whether the applicable standard is the one where consumers live or have moved to subsequently, where the firm is located, or where the Internet site that was used is based. This provision alone is enough reason to oppose the proposal.

- *Resist giving the FDIC resolution authority for "Too Big to Fail" financial firms.* Dealing with failing financial companies that could jeopardize the financial system is a valid concern, but the Administration's approach seems more geared toward facilitating future bailouts and justifying additional intervention.

  Over the past 18 months, policymakers found that while they had the ability to close failing banks, the only way they could close bank holding companies, insurance companies, and similar firms was to essentially buy them from shareholders. This left taxpayers in the unenviable position of having to repeatedly bail out companies like AIG.

  Closing down multi-national financial firms is not easy. The collapse of Lehman Brothers resulted in about 92 subsidiaries going into bankruptcy, only 20 of which were located in the U.S. and came under American jurisdiction. Clearly, a receiver/conservator that can operate at least certain subsidiaries until they can be sold or orderly closed is necessary in order to maximize returns to debtors. But the Treasury plan assumes that the Federal Deposit Insurance Corporation (FDIC) should handle this role rather than allowing the courts to determine a receiver and then supervise it. While the FDIC has broad experience with resolving failed banks, it has no experience with the broader financial activities which will almost certainly be part of failing large financials.

Moving Toward Real Financial Regulatory Reform. Instead, the President and Congress should explore the following key policies and principles during its deliberations over financial markets:

- *Bankruptcy, not bailouts.* Rather than giving a government agency the ability to take over and operate large financial institutions, bankruptcy law ought to be modified to accommodate the special problems of resolving these firms and also allow the courts to appoint receivers with the specialized knowledge necessary to best deal with their failure. By operating under the supervision of a court with the eventual goal of liquidation, the impact on the rest of the industry is likely to be less than with a regulatory takeover. Such a move would prevent most future bailouts, in part by discouraging companies from risky behavior.
- *Consolidate financial regulators to modernize the regulator framework.* The current multi-regulator system reflects the financial industry of the 1930s, not today's reality. For instance, merging the functions of the Office of Thrift Supervision and the Office of the Comptroller of the Currency—along with the supervisory functions of the Federal Deposit Insurance Corporation and the Federal Reserve—is a good start toward a more efficient and less burdensome financial regulatory structure. Other targets could include merging the Commodities Futures Trading Commission (CFTC) into the Securities and Exchange Commission (SEC). While the CFTC was once focused on agricultural futures, today those products make up only about 15 percent of its regulatory activities. The main stumbling block is that the CFTC is under Congress's agriculture com-

mittees, while the SEC falls under the financial services committees. This is yet another obsolete arrangement that should be modernized.

- *Privatize Fannie Mae and Freddie Mac.* For decades before their takeover last year, the government-created Freddie Mac and Fannie Mae dominated and distorted the housing finance market. Ultimately, their business model distributed profits to shareholders while sharing losses with the taxpayers. Now that they have been seized by regulators, it is time to gradually eliminate their ties to government, reduce their size, and eventually allow them to compete on an equal basis with private companies.
- *Use capital requirements to reduce the systemic risk of large financial institutions.* Rather than seeking to micro-manage "too big to fail" financial institutions, it would be better to require them to have more capital than is required for smaller financial institutions. The additional capital would represent the risk that failure of huge financial institutions could destabilize the entire financial system.

Implementing Good Policy Is Preferable to Action for Action's Sake. Over the next year, Congress will continue to try to reform financial regulations. However, for Congress, acting quickly seems to be almost as important as the actual content of the legislation passed. The old advice "act in haste, repent at leisure" applies especially to the highly complex world of finance and financial regulation. Regardless of the President's call for action, Congress should carefully consider both the Administration's proposals and any alternatives before legislating.

—David C. John is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.