Commentary

A New Regulatory Framework
Luigi Zingales 03.31.09, 5:35 PM ET

The American system of financial regulation is a patchwork of agencies. At least 10 federal regulators oversee financial-services companies; different regulators sometimes supervise the same entities; and since the onset of the financial crisis, regulatory agencies have taken on roles not originally envisioned or mandated, leading to further redundancy. This patchwork is not the creation of a schizophrenic legislator, but rather the accumulation of a century of financial crises, each of which led to the creation of a new agency. In the current crisis, instead of forming yet another agency, we should rethink the country's financial regulatory architecture entirely.

History shows why our regulatory system is such a hodgepodge. The Federal Reserve was created in 1913 to address the liquidity problems experienced during the panic of 1907; eventually the Fed became responsible for controlling inflation and unemployment. The Federal Deposit Insurance Corp. (FDIC) was born in 1933 to prevent the kind of bank runs that had forced more than 5,000 banks to close in the early 1930s.

The Securities and Exchange Commission (SEC) came into being in 1934 to prevent the stock-market manipulations that had prevailed during the 1920s. And the Office of Thrift Supervision was created in 1989, following the savings-and-loan crisis of the late '80s. In fact, the Commodities Future Trading Commission (CFTC) is the only financial regulatory agency not created following a crisis; it came about in 1974 as the result of the intense lobbying by Chicago exchanges to protect their autonomy from New York.

So it's not surprising, when you consider their origins, that these agencies have recently been stepping on one another's toes. Transparency and investor protection, for example, have been pursued not just by the SEC (its proper role) but also by the CFTC and the Fed. Similarly, the Fed, the FDIC and the SEC have all been trying to help stabilize the financial system since the crisis began.

The current regulatory system runs into problems with coordination and the communication of information. Lack of coordination across different agencies can tempt industry to avoid regulation entirely. For example, state insurance regulators never oversaw credit default swaps, even though they were essentially insurance products, because they were called "swaps," which made them sound like standard derivatives. As for communication of information, consider the Bear Steams crisis. Because the Fed didn't regulate investment banks--that was the SEC's job--it didn't learn in time the extent of Bear's poor financial condition or the risks that Bear's failure would pose to the entire banking system, and in consequence, it had no time to plan a possible intervention.

How to fix these problems? One common suggestion is centralization, in which all regulatory functions are rolled up into one organization, as Britain does with its Financial Service Authority (FSA). In practice, however, even the FSA represents only a partial centralization, because some key monetary-policy functions remain with the Bank of England.

And during the Northern Rock crisis, Britain's supposedly centralized system failed at the very goal for which it was created: effective coordination. Another possibility is the so-called functional approach to regulation, in which regulators oversee entities according to the kind of function that those entities perform. So, for instance, the same regulator would oversee money market funds and banks, since they perform the same function--providing short-term liquidity to individuals and firms.

But the functional approach does nothing to eliminate two major problems with our current regulatory system. The first is the trade-off among different objectives. At the risk of oversimplification, I would say that government intervention in the financial system has three main goals: price stability, financial-system stability and protecting investors and borrowers against fraud and abuses. At present, the various regulatory agencies have to make troubling trade-offs among these three objectives.
For example, when the Fed extended a loan to **Citigroup**'s ring-fenced toxic assets to help prop up the bank, it traded off price stability for financial stability. If those assets were to turn out to be worth much less than expected, the Fed would find it impossible to recoup the liquidity it injected, which would risk causing an increase in inflation, because it would have pumped money into the economy backed by nothing.

Similarly, when the Financial Accounting Standards Board (FASB) initiates new rules on mark-to-market accounting, it swaps the goal of transparency (and thus investor protection) for the goal of system stability, which can be compromised by the fact that mark-to-market may exacerbate economic cycles. Having such trade-offs made within agencies, and thus non-transparently, poses serious risks.

The second problem with our current system is that when responsibilities are allocated across agencies, it's difficult to hold any one agency or individual accountable for any outcome. Whose fault was it that Bear Stearns was forced into a shotgun merger with JPMorgan Chase? Was it the SEC's, for failing to oversee the risk of investment banks, or the Fed's, for failing to provide liquidity, or a lack of coordination between the two, or all of the above? As long as fundamental goals are divided among organizations, the blame game will prevent each from taking responsibility for the results.

Hence the need to rethink regulatory architecture along clear lines of responsibility and goals. I propose that we allocate financial regulation and supervision to three different agencies, each responsible for only one of the three principal goals of financial-system regulation. One agency would be in charge of price stability, more or less conducting the traditional monetary policy that the Fed currently conducts. A second agency would be tasked with systemic considerations, absorbing some of the extraordinary roles that the Fed has taken on during the current crisis, together with other solvency issues (often overseen by state insurance regulators). Finally, a third agency would focus on protecting the little guys, whether they're investing in stock, depositing funds at a bank, borrowing from a bank or buying an annuity or other insurance product.

The beauty of such a system is that each of the three agencies would have a very simple and easily measurable goal. The price-stability agency would have to control inflation. Its effectiveness could be easily measured by the inflation expectations embedded in the difference between standard Treasury bonds and Treasury inflation-protected securities (TIPS). The system-stability agency's goal would be minimizing the risk of a systemic collapse. Its accomplishments could be measured by the price of credit-default swaps on the major financial institutions, which captures the probability that these institutions might fail.

Finally, the investor-protection agency's success could be measured through surveys of the trust that people feel in the stock market and other financial institutions. Major trade-offs among these goals—which, as we've seen, present serious problems in the existing setup—would have to occur across agencies, not within them, and thus be conducted in a more transparent fashion.

The main challenge of such a design would be striking these compromises across agencies and communicating crucial information among them. A new board could be set up consisting of the heads of the three agencies, together with a small number of other Senate-appointed representatives. Just as with the Fed board, the minutes of this new board would be publicly released (possibly with a delay), so that the trade-off decisions were transparent and the responsibility for them clearly allocated.

The current financial crisis is not due to lack of regulation, as many like to say, but to poorly designed and poorly enforced regulation. A better regulatory regime, based not on historical accident but on the chief objectives of financial regulation, would help prevent future crises and help our economy regain its vibrancy.

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