ROOM for DEBATE

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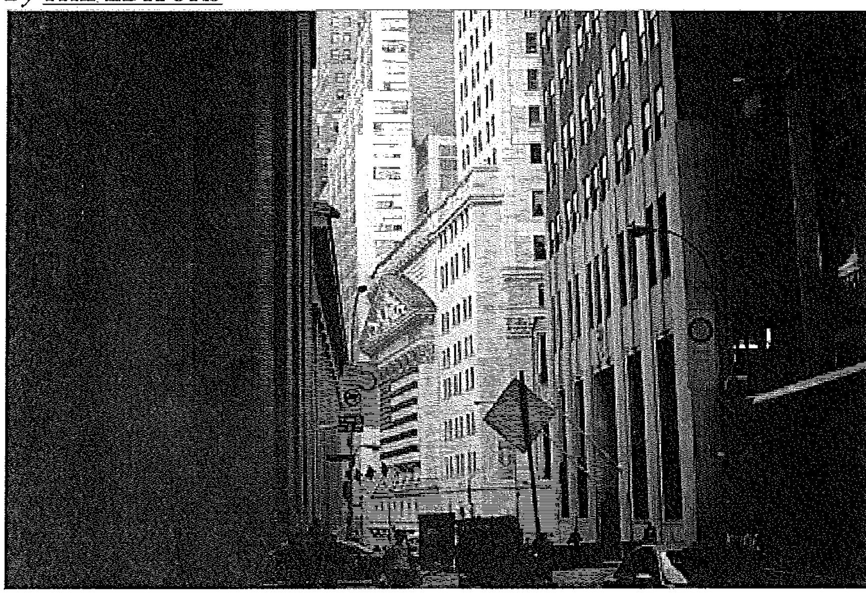
Why Wall Street Reforms Have Stalled

By THE EDITORS



Todd Heisler/The New York Times

Lower Manhattan, near Wall Street.

Updated, Sept. 12, 9:05 a.m. | Scott Reynolds Nelson, a historian of American financial crises, discusses the reliance and conflict between the federal government and financiers going back to the nation's founding.

One year ago next week, Lehman Brothers went bankrupt, Merrill Lynch was sold and A.I.G. was rescued by a huge federal bailout. In the wake of the global financial crisis, Congress and regulators vowed to end Wall Street's profligate risk-taking and the compensation structures that rewarded that behavior. Yet looking back, experts say not a lot has changed in that culture, and efforts to control risk and reform executive pay have stalled.

Why is it so hard to regulate Wall Street? Has the financial industry always been better able to block government reforms than other industries?

- Yves Smith, financial analyst
- Russell Roberts, professor of economics
- Jeffry A. Frieden, professor of government
- Nicole Gelinas, Manhattan Institute
- William K. Black, former banking regulator

- Edward Harrison, banking and finance specialist
- Scott Reynolds Nelson, professor of history

Too Much Power for the Few

***Yves Smith** has written the blog Naked Capitalism since 2006. She has spent more than 25 years in the financial services industry and currently is head of Aurora Advisors, a management consulting firm.*

Wall Street has become hard to regulate because we've allowed it to evolve that way. Credit is vital to any economy beyond the barter stage. As commerce became large scale and more interconnected, bank failures, which were once local affairs, increasingly led to widespread panics that produced considerable harm. As a result, government not only started to provide more safety nets for banks but also supervised them and placed limits on their activities.

> It is pretty hard to regulate someone who has a knife at your throat.

Since the 1980s, lending has shifted from banks to the capital markets. While many loans do remain with the bank that originated them, in the U.S., what Treasury Secretary Timothy Geithner has called "market-based credit" has become prevalent. Even though a bank initially extends the loan, it is often on-sold through capital markets firms to investors.

That process gives major financial players control over the all-important over-the-counter debt markets. Most of these deals do not trade much once sold, making them ill-suited to shift on to exchanges that would be easier to police. But these over-the-counter markets have, for a host of reasons, strong scale economies and network effects, so absent intervention, it was inevitable that they would become increasingly concentrated, with a comparatively small number of firms becoming dominant.

It is pretty hard to regulate someone who has a knife at your throat.

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Misbehaving Children, Indulgent Parents

***Russell Roberts** is a research fellow at Stanford University's Hoover Institution and professor of economics at George Mason University. He is the host of EconTalk, a weekly podcast.*

Wall Street appears to be back to business as usual, but this is a bit deceptive. First, capital buffers are up and leverage is down. People are worried about the future and they should be. Some natural forces are reining in some of the excesses of the recent past.

Should we try to do more explicitly to change how Wall Street operates? One mistake we are making is to re-create what got us here in the first place. The Federal Reserve has bought hundreds of billions of dollars of assets from Fannie and Freddie in a desperate attempt to shore up the housing market artificially. I am not optimistic on how this will turn out.

> For three decades, the government has rescued virtually every large troubled financial institution — to bad effect.

There is also a focus on regenerating the securitization market. But people are very wary of securitization and rightfully so. Perhaps it is wise to let securitization die for now. Maybe it will return. To force it back into life is a mistake.

What about more explicit regulation to shape compensation, capital requirements, and the risks that financial institutions are allowed to take? That will be the natural focus of the next regulatory regime that will inevitably arise once the economy has recovered and Washington's direct role in financial institutions gets back to normal.

Past attempts of explicit regulation have been ineffective. It's like re-inventing a broken wheel. Perhaps it's time to look elsewhere for stability.

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Captured Regulators

***Jeffry A. Frieden**, a professor of government at Harvard, is the author of* *Global Capitalism: Its Fall and Rise in the Twentieth Century."*

It has been difficult to move forward rapidly to reform the American financial regulatory system. This is not surprising. Financial regulation in the United States has always been arcane, complex, and resistant to change. There are several reasons, all of which come down the one overarching reality: financial regulation is extraordinarily political, and confronts powerful interests.

> Financial regulators tend to be sympathetic to interests of financial institutions, which makes them reluctant to make changes that would be costly or difficult.

Special-interest politics. Regulatory agencies are often sympathetic to the industries they regulate. This pattern is so well known among scholars that it has a name: "regulatory capture." This effect can be due to the political influence of the industry on its regulators; or to the fact that the regulators spend so much time with their charges that they come to accept their world view; or to the prospect of lucrative private-sector jobs when regulators retire or resign.

Whatever the reason, financial regulators tend to be sensitive to the views and interests of financial institutions, which makes them reluctant to make changes that would be costly or difficult.

Technical complexity. The "capture" of financial regulators is facilitated by the extraordinary complexity of modern finance. Very few consumers, or politicians, understand the financial markets and institutions that regulators supervise. And very few care much about them, in normal times.

For their part, regulators cannot usually afford to hire all the expensive financial experts they need. This means that the regulators' principal source of information and attention is the financial institutions themselves. This was codified in some of the regulatory mistakes made in the run-up to the crisis, such as when regulators — in the United States and in many other countries — accepted the argument that banks themselves were best suited to evaluating the riskiness of some of their most complicated holdings.

Fragmentation. American bank regulation is among the most fragmented in the world. Each state has its own bank regulator; there are often separate regulations and regulators for each variety of bank (commercial banks, savings and loans, credit unions); and financial institutions that look a lot like banks are typically regulated by other agencies.

The proliferation of regulators means that financial institutions are often able to "jurisdiction-shop" for the most favorable regulatory environment. It also means that each of the dozens of regulators jealously guards its independence. Attempts to consolidate regulation, for example, run up against the states and their regulators, the disparate federal agencies, and their Congressional and private-sector supporters.

Uncertainty. One of the most important tasks of financial regulators is devising policies toward new financial instruments. This is also one of the most daunting tasks, as the new instruments are typically not well understood — indeed, they may have been devised precisely to avoid easy control by the regulators. Most observers did not understand how risky the new American mortgage-backed securities might be until they collapsed, bringing the financial system and the rest of the world economy down with them.

For financial regulation to be reformed in line with the true public interest, then, requires an almost magical combination. Policymakers and regulators must be generally immune to political pressure from the financial services industries. Reformers have to have a broad and deep understanding of the great complexity of modern finance. Central policymakers need to be willing and able to override the opposition of existing, turf-protecting, state and federal regulators. And enough people have to care, and to be paying attention, to get politicians to focus on the topic and push it to a conclusion.

In the aftermath (or what may be in the midst) of the gravest financial crisis in the United States in 75 years, all of these stars may be aligned. The opportunities for fundamental regulatory reform are probably greater now than they have been since the Great Depression.

Even so, it will require an enormous amount of expertise, perseverance, and political courage to pull it off.

Close

Restore Market Discipline

***Nicole Gelinas**, a Manhattan Institute senior fellow, is author of the forthcoming "After The Fall: Saving Capitalism from Wall Street – and Washington."*

Adequately regulating finance is easier than Wall Street and Washington would like the public to think.

Most important, Washington must restore market discipline, which has been missing since 1984, when the Reagan administration decided with its Continental Illinois rescue that some banks were "too big to fail."

> Make lenders, including those "too big to fail," suffer the consequences of their bad decisions.

Investors learned from the experience and from subsequent episodes that the government would not allow lenders to some financial firms to suffer the consequences of their bad decisions. When the government subsidizes something, as it did with this implicit guarantee, it gets more of it. That's how we eventually got record levels of financial-industry debt.

Lawmakers and regulators must permanently remove this subsidy by prescribing a consistent, predictable way in which large or complex financial firms can fail, with lenders, too, taking warranted losses. Without this framework, other regulatory efforts will be ineffective. Financial firms insulated from market discipline will find