Congressional Oversight Panel

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SPECIAL REPORT ON REGULATORY REFORM

Modernizing the American Financial Regulatory System: Recommendations for Improving Over-sight, Protecting Consumers, and Ensuring Stability*

*Submitted under Section 125(b)(2) of Title I of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343

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I. Executive Summary

1. Lessons from the Past

Financial crises are not new. As early as 1792, during the presidency of George Washington, the nation suffered a severe panic that froze credit and nearly brought the young economy to its knees. Over the next 140 years, financial crises struck on a regular basis—in 1797, 1819, 1837, 1857, 1873, 1893–96, 1907, and 1929–33—roughly every fifteen to twenty years.

But as the United States emerged from the Great Depression, something remarkable happened: the crises stopped. New financial regulation—including federal deposit insurance, securities regulation, and banking supervision—effectively protected the system from devastating outbreaks. Economic growth returned, but recurrent financial crises did not. In time, a financial crisis was seen as a ghost of the past.

After fifty years without a financial crisis—the longest such stretch in the nation's history—financial firms and policy makers began to see regulation as a barrier to efficient functioning of the capital markets rather than a necessary precondition for success.

This change in attitude had unfortunate consequences. As financial markets grew and globalized, often with breathtaking speed, the U.S. regulatory system could have benefited from smart changes. But deregulation and the growth of unregulated, parallel shadow markets were accompanied by the nearly unrestricted marketing of increasingly complex consumer financial products that multiplied risk at every stratum of the economy, from the family level to the global level. The result proved disastrous. The first warning followed deregulation of the thrifts, when the country suffered the savings and loan crisis in the 1980s. A second warning came in 1998 when a crisis was only narrowly averted following the failure of a large unregulated hedge fund. The near financial panic of 2002, brought on by corporate accounting and governance failures, sounded a third warning.

The United States now faces its worst financial crisis since the Great Depression. It is critical that the lessons of that crisis be studied to restore a proper balance between free markets and the regulatory framework necessary to ensure the operation of those markets to protect the economy, honest market participants, and the public.

2. Shortcomings of the Present

The current crisis should come as no surprise. The present regulatory system has failed to effectively manage risk, require sufficient transparency, and ensure fair dealings.

Financial markets are inherently volatile and prone to extremes. The government has a critical role to play in helping to manage both public and private risk. Without clear and effective rules in place, productive financial activity can degenerate into unproductive gambling, while sophisticated financial transactions, as well as more ordinary consumer credit transactions, can give way to swindles and fraud.

A well-regulated financial system serves a key public purpose: if it has the power and if its leaders have the will to use that power, it channels savings and investment into productive economic activity and helps prevent financial contagion. Like the management of any complex hazard, financial regulation should not rely on a single magic bullet, but instead should employ an array of related measures for managing various elements of risk. The advent of the automobile brought enormous benefits but also considerable risks to drivers, passengers, and pedestrians. The solution was not to prohibit driving, but rather to manage the risks through reasonable speed limits, better road construction, safer sidewalks, required safety devices (seatbelts, airbags, children's car seats, antilock breaks), mandatory automobile insurance, and so on. The same holds true in the financial sector.

In recent years, however, the regulatory system not only failed to manage risk, it also failed to require disclosure of risk through sufficient transparency. American financial markets are profoundly dependent upon transparency. After all, the fundamental risk/reward corollary depends on the ability of market participants to have confidence in their ability to accurately judge risk.

Markets have become opaque in multiple ways. Some markets, such as hedge funds and credit default swaps, provide virtually no information. Even so, disclosure alone does not always provide genuine transparency. Market participants must have useful, relevant information delivered in an appropriate, timely manner. Recent market occurrences involving off-balance-sheet entities and complex financial instruments reveal the lack of transparency resulting from the wrong information disclosed at the wrong time and in the wrong manner. Mortgage documentation suffers from a similar problem, with reams of paper thrust at borrowers at closing, far too late for any borrower to make a well-informed decision. Just as markets and financial products evolve, so too must efforts to provide understanding through genuine transparency.

To compound the problem associated with uncontained and opaque risks, the current regulatory framework has failed to ensure fair dealings. Unfair dealing can be blatant, such as outright deception or fraud, but unfairness can also be much more subtle, as when parties are unfairly matched. Individuals have limited time and expertise to master complex financial dealings. If one party to a transaction has significantly more resources, time, sophistication or experience, other parties are at a fundamental disadvantage. The regulatory system should take appropriate steps to level the playing field.

Unfair dealings affect not only the specific transaction participants, but extend across entire markets, neighborhoods, socioeconomic groups, and whole industries. Even when only a limited number of families in one neighborhood have been the direct victims of a predatory lender, the entire neighborhood and even the larger community will suffer very real consequences from the resulting foreclosures. As those consequences spread, the entire financial system can be affected as well. More importantly, unfairness, or even the perception of unfairness, causes a loss of confidence in the marketplace. It becomes all the more critical for regulators to ensure fairness through meaningful disclosure, consumer protection measures, stronger enforcement, and other measures. Fair dealings provide credibility to businesses and satisfaction to consumers.

In tailoring regulatory responses to these and other problems, the goal should always be to strike a reasonable balance between the costs of regulation and its benefits. Just as speed limits are more stringent on busy city streets than on open highways, financial regulation should be strictest where the threats—especially the threats to other citizens—are greatest, and it should be more moderate elsewhere.

3. Recommendations for the Future

Modern financial regulation can provide consumers and investors with adequate information for making sound financial decisions and can protect them from being misled or defrauded, especially in complex financial transactions. Better regulation can reduce conflicts of interest and help manage moral hazard, particularly by limiting incentives for excessive risk taking stemming from often implicit government guaranties. By limiting risk taking in key parts of the financial sector, regulation can reduce systemic threats to the broader financial system and the economy as a whole. Ultimately, financial regulation embodies good risk management, transparency, and fairness.

Had regulators given adequate attention to even one of the three key areas of risk management, transparency and fairness, we might have averted the worst aspects of the current crisis.

1. Risk management should have been addressed through better oversight of systemic risks. If companies that are now deemed "too big to fail" had been better regulated, either to diminish their systemic impact or to curtail the risks they took, then these companies could have been allowed to fail or to reorganize without taxpayer bailouts. The creation of any new implicit government guarantee of high-risk business activities could have been avoided.
2. Transparency should have been addressed though better, more accurate credit ratings. If companies issuing high-risk credit instruments had not been able to obtain AAA ratings from the private credit rating agencies, then pension funds, financial institutions, state and local municipalities, and others that relied on those ratings would not have been misled into making dangerous investments.
3. Fairness should have been addressed though better regulation of consumer financial products. If the excesses in mortgage lending had been curbed by even the most minimal consumer protection laws, the loans that were fed into the mortgage backed securities would have been choked off at the source, and there would have been no "toxic assets" to threaten the global economy.

While the current crisis had many causes, it was not unforeseeable. Correcting the mistakes that fueled this crisis is within reach. The challenge now is to develop a new set of rules for a new financial system.

The Panel has identified eight specific areas most urgently in need of reform:

1. Identify and regulate financial institutions that pose systemic risk.
2. Limit excessive leverage in American financial institutions.
3. Increase supervision of the shadow financial system.
4. Create a new system for federal and state regulation of mortgages and other consumer credit products.
5. Create executive pay structures that discourage excessive risk taking.
6. Reform the credit rating system.
7. Make establishing a global financial regulatory floor a U.S. diplomatic priority.
8. Plan for the next crisis.

While these are the most pressing reform recommendations, many other issues merit further study, the results of which the Panel will present in future reports. Despite the magnitude of the task, the central message is clear: through modernized regulation, we can dramatically reduce the risk of crises and swindles while preserving the key benefits of a vibrant financial system

Americans have paid dearly for this latest crisis. Lost jobs, failed businesses, foreclosed homes, and sharply cut retirement savings have touched people all across the county. Now every citizen—even the most prudent—is called on to assume trillions of dollars in liabilities spent to try to repair a broken system. The costs of regulatory failure and the urgency of regulatory reform could not be clearer.

***Action item*: Encourage corporate governance structures with stronger board and long-term investor oversight of pay packages.**

The Associated Press recently reported that "even where banks cut back on pay, some executives were left with seven- or eight-figure compensation that most people can only dream about. Richard D. Fairbank, the chairman of Capital One Financial Corp., took a $1 million hit in compensation after his company had a disappointing year, but still got $17 million in stock options. The McLean, Va.-based company received $3.56 billion in bailout money on Nov. 14."[78]

Corporate governance regulations should strengthen the role of boards and long-term shareholders in the executive pay process with the goal of encouraging executive pay practices that align executives' interests with the long-term performance of the businesses they manage

The twin problems of asymmetric and short-term-focused executive pay have been the subject of a number of reform efforts by business groups. Such reform recommendations have come from the Conference Board, in its report on the origins of the financial crisis,[79] and from the Aspen Institute's Principles for Long Term Value Creation,[80] endorsed by the U.S. Chamber of Commerce and the Business Roundtable, as well as by the Council of Institutional Investors and the AFL-CIO.

Financial regulators should encourage these efforts wherever possible and provide assistance wherever practicable.

6. Reform the Credit Rating System

***Problem with current system*: The credit rating system is ineffective and plagued with conflicts of interest.**

The major credit rating agencies played an important—and perhaps decisive—role in enabling (and validating) much of the behavior and decision making that now appears to have put the broader financial system at risk. In the subprime-related market specifically, high ratings for structured financial products—especially mortgage-backed securities (MBS), collateralized debt obligations (CDO), and CDOs that invested in other CDOs (frequently referred to as CDO-squared, or CDO^2)—were essential for ensuring broad demand for these products. High ratings not only instilled confidence in potentially risk-averse investors, but also helped satisfy investors' regulatory requirements, which were often explicitly linked to ratings from the major credit rating agencies. By 2006, Moody's business in rating structured financial products accounted for 44 percent of its revenues, as compared to 32 percent from its traditional corporate-bond rating business.[81] It has also been reported that "roughly 60 percent of all global structured products were AAA-rated, in contrast

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[78] Frank Bass and Rita Beamish, *Study: $1.6B of Bailout Funds Given to Bank Execs*, Associated Press (Dec. 21, 2008).

[79] Conference Board, Linda Barrington, Ellen S. Hexter, and Charles Mitchell, *CEO Challenge 2008: Top 10 Challenges—Financial Crisis Edition* (Nov. 2008) (online at www.conference-board.org/publications/describe.cfm?id=1569).

[80] Aspen Institute, *Long-Term Value Creation: Guiding Principles for Corporations and Investors* (2008).

[81] Harvard Business School, Joshua D. Coval, Jakib Jurek, and Erik Stafford, *The Economics of Structured Finance*, at 4 (2008) (Working Paper No. 09-060) (online at papers.ssrn.com/sol3/papers.cfm?abstract_id=1287363).

to less than 1 percent of corporate issues."[82] Financial firms, from Fannie Mae to AIG, also benefited greatly from having high credit ratings of their own—especially AAA—allowing them not only to borrow at low rates on the short-term markets to finance longer-term (and higher yielding) investments but also to sell guaranties of various sorts, effectively "renting out" their credit rating.

Numerous explanations have been offered for credit rating agencies' apparent mistakes, including conflicts of interest, misuse of complex models, and their quasi-public status as nationally recognized statistical rating organizations (NRSROs).

Regarding conflicts of interests, worrisome is the rating agencies' practice of charging issuers for their ratings, a practice that began at Fitch and Moody's in 1970 and at Standard & Poor's a few years later.[83] Although the practice of collecting payments from issuers has long provoked criticism, market observers often downplayed these concerns, suggesting that "the agencies have an overriding incentive to maintain a reputation for high-quality, accurate ratings."[84] Others, however, claim that the "issuer pays" model biases ratings upward and also encourages "ratings shopping" by issuers, which in turn provokes a race to the bottom on the part of the rating agencies, each willing to lower quality standards to drum up more business.[85]

Beyond the ratings themselves, credit rating agencies also charge issuers for advice, including pre-rating assessments (in which issuers learn what ratings will likely be under various hypothetical scenarios) and risk-management consulting. In some cases, credit rating agency analysts subsequently go to work for the companies they had been rating.[86] This revolving-door practice creates not only the potential for conflicts of interest but also for gaming of the system, since former employees of the rating agencies presumably know how best to exploit weaknesses in the agencies' risk assessment models.

Many critics charge that it was the models themselves—and overreliance on them—that got the credit rating agencies into trouble in recent years, particularly in assigning ratings to structured financial products. "Instead of focusing on actual diligence of the risks involved, demanding additional issuer disclosures, or scrutinizing collateral appraisers' assessments," writes one skeptic, "rating agencies primarily relied on mathematical models that estimated the loss distribution and simulated the cash flows of RMBS [residential mortgage backed securities] and CDOs using historical data."[87]

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[82] *Id.*

[83] Richard Cantor and Frank Packer, *The Credit Rating Industry*, FRBNY Quarterly Review, at 4 (Summer–Fall 1994). *See also* Claire Hill, *Regulating the Rating Agencies*, Washington University Law Quarterly, at 50 (2004).

[84] Cantor and Packer, *supra* note 81, at 4.

[85] House Committee on Oversight and Government Reform, Testimony of Jerome S. Fons, *Credit Rating Agencies and the Financial Crisis*, 110th Cong., at 3 (Oct. 22, 2008) (online at oversight.house.gov/documents/20081022102726.pdf).

[86] John P. Hunt, *Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, Columbia Business Law Review, at 32-33 (2009) (papers.ssrn.com/sol3/papers.cfm?abstract_id=1267625).

[87] Jeffrey David Manns, *Rating Risk after the Subprime Mortgage Crisis: A User Fee Approach for Rating*

Many of the models involved excessively rosy assumptions about the quality of the underlying mortgages, ignoring the fact that these mortgages (especially subprime mortgages) were far riskier than ever before and were in fact becoming steadily riskier year by year.[88] Credit rating agency modeling of mortgage-related securities may also have involved mistaken assumptions about the independence of the underlying mortgages—including the assumption that defaults would not be highly correlated across a broad bundle of mortgages or mortgage-related securities.[89] By extension, many of the rating agencies' models may also have involved overly optimistic assumptions about the direction of housing prices (that is, that they would not fall by much, if at all). When asked on a conference call in March 2007 about how a 1 to 2 percent decline in home prices over an extended period of time would affect Fitch's modeling of certain subprime-related securities, a Fitch representative conceded, "The models would break down completely."[90]

Yet another problem plaguing the rating agencies' models was the practice of embedded structuring by issuers, according to which CDOs would themselves become inputs into new CDOs (CDO^2). "With multiple rounds of structuring," three finance professors explain, "even minute errors at the level of the underlying securities, which would be insufficient to alter the security's rating, can dramatically alter the ratings of the structured finance securities."[91]

Of particular concern from a regulatory standpoint is the extent to which state and federal (and even global) financial regulations are linked to private credit ratings—and, in fact, to ratings issued by just a handful of specially designated credit rating agencies, the NRSROs). To the extent that leading credit rating agencies enjoy a protected status and virtually guaranteed demand as a result of their regulatory significance, they may face diminished incentives to maintain the quality of their ratings.

The SEC has recently undertaken a number of reforms aimed at the operations of the NRSROs pursuant to the passage of the Credit Rating Agency Reform Act of 2006 (the Rating Agency Act),[92]

Agency Accountability, North Carolina Law Review (forthcoming), at 32–33 (papers.ssrn.com/sol3/papers.cfm?abstract_id=1199622) (accessed Jan. 4, 2009).

[88] U.S. Securities and Exchange Commission Office of Compliance Inspections and Examinations, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies,* at 33 (July 2008) (online at www.sec.gov/news/studies/2008/craexamination070808.pdf) (hereinafter "Summary Report") ("In addition to the recent growth in subprime origination, there has also been a growth in the risk factors associated with subprime mortgages. Studies indicate that the percentage of subprime loans with less-than-full documentation, high combined loan to total value (CLTVs), and second liens grew substantially between 1999 and 2006. Notably, while 2/28 adjustable rate mortgages comprised just 31 percent of subprime mortgages in 1999, they comprised almost 69 percent of subprime loans in 2006. Further, 40-year mortgages were virtually non-existent prior to 2005, but they made up almost 27 percent of the subprime loans in 2006. These data provide evidence that the majority of subprime origination occurred within the last five years, and the loans containing very high risk combinations are even more recent."). The SEC report also documented that, at one major credit rating agency, "the average percentage of subprime RMBS in the collateral pools of CDOs it rated grew from 43.3 percent in 2003 to 71.3 percent in 2006." *Id.* at 7. Given these dramatic changes in the mortgage market, basing models on historical mortgage data may have proved particularly problematic.

[89] Indeed, a significant degree of independence was essential, since "CDOs rely on the power of diversification to achieve credit enhancement." Coval, et al., *supra* note 81, at 10.

[90] *See id.* at 23.

[91] *Id.* at 10.

[92] Credit Rating Agency Reform Act of 2006, P. Law No. 109-291.

which granted the SEC authority to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies. Before this grant of authority to the SEC, NRSROs were essentially unregulated. Pursuant to its new regulatory authority, the SEC has registered ten firms;[93] instituted examinations of NRSROs' practices;[94] and proposed rules designed to enhance accountability, transparency, and competition.[95] The Rating Agency Act and the SEC's recent regulatory activity are positive developments. However, since 2006 the financial crisis has revealed the extent of the harmful consequences of the deep-seated conflicts of interest and distorted incentives associated with the credit ratings firms. With the knowledge that the contours of reform of credit rating agency regulation must take into account the SEC's actions, we propose the following recommendations.

***Action item*: Adopt one or more regulatory options to address conflicts of interest and incentives.**

To address conflicts of interest, the SEC or a new regulatory body (see below) could impose limits on the proportion of revenues of rating agencies that are derived from issuers, though there is disagreement about whether alternative revenue sources would prove sufficient.[96] Alternatively, for each rating, issuers could be required to pay into a pool, from which a rating agency would be chosen at random.[97] Here, the challenge would be to maintain the quality of ratings after severing the link between pay and performance. One could also imagine the introduction of grace periods in which credit rating analysts could not take jobs with their clients. While this too would limit conflicts of interest, it might also interfere with the recruiting of high-quality credit analysts at the rating agencies.

To improve incentives, the SEC or some other regulatory body should further encourage additional competition by progressively expanding the ranks of the NRSROs.[98] Other options would include additional disclosure requirements or prohibitions on rating agencies' use of nonpublic information.[99] Since rating agencies currently face little if any legal liability for malfeasance in the production of ratings, a number of experts have proposed strategies for imposing liability on credit

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[93] U.S. Securities Exchange Commission, *Nationally Recognized Statistical Rating Organizations* (online at www.sec.gov/divisions/marketreg/ratingagency.htm) (accessed Jan. 26, 2008) (hereinafter "SEC NRSRO Web site"). These ten include the old line firms Moody's, Standard & Poor's, and Fitch. *Id.*

[94] Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Christopher Cox, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies,* 110th Cong. (Apr. 22, 2008) (online at www.sec.gov/news/testimony/2008/ts042208cc.htm).

[95] SEC NRSRO Web site, *supra* note 93.

[96] House Committee on Oversight and Government Reform, Testimony of Sean J. Egan, *Credit Rating Agencies and the Financial Crisis*, 110th Cong., at 9 (Oct. 22, 2008) (online at oversight.house.gov/documents/20081022102906.pdf).

[97] David G. Raboy, *Concept Paper on Credit Rating Agency Incentives* (Jan. 9, 2009) (unpublished working paper on file with the Panel).

[98] Hill, *supra* note 83, at 86–87.

[99] Egan, *supra* note 96, at 8.

rating agencies to ensure appropriate accountability.[100] Although such reforms might well prove helpful, they would be unlikely to solve the underlying problem by themselves.

***Action item*: Reform the quasi-public role of NRSRO's and consider creating a Credit Rating Review Board.**

Perhaps the most pressing issue of all from a regulatory standpoint is the NRSRO designation itself. Particularly given all of the concerns that have been raised about the credit rating agencies and their poor performance leading up to the current crisis, state and federal policymakers will need to reassess whether they can continue to rely on these private ratings as a pillar of public financial regulation.[101] In fact, it may be time to consider the possibility of eliminating, or at least dramatically scaling back, the NRSRO designation and replacing it with something else.[102]

One option would be to create a public entity—a Credit Rating Review Board—that would have to sign off on any rating before it took on regulatory significance. Even if an asset was rated as investment grade by a credit rating agency, it could still not be added to a bank or pension fund portfolio, for example, unless the rating was also approved by the review board. Ideally, the board would be given direction by lawmakers to favor simpler (plain vanilla) instruments with relatively long track records. New and untested instruments might not make the cut. Of course, such new instruments could still be actively bought and sold in the private marketplace. Only regulated transactions that currently require ratings would be effected. Two key advantages of this approach are that it would permit a dramatic opening of the market for private credit ratings and at the same time discontinue the unsuccessful outsourcing of vital regulatory monitoring.

Another, substantially different, option for the design of such a Credit Rating Review Board would be to model the board in part on the Public Company Accounting Oversight Board (PCAOB), a nont-for-profit corporation that was created by the Sarbanes-Oxley Act to oversee the auditors of public companies.[103] Under this model, the Credit Rating Review Board would not rate instruments ex ante, but instead audit ratings after the fact, perhaps on an annual basis, to ensure that rating agencies are sufficiently disclosing their rating methodologies, the ratings agencies' methodologies are sound, and the rating agencies are adhering to their methodologies. Depending on the course of the SEC's rulemaking, the Credit Rating Review Board could coordinate with or assume some of the SEC's authority to regulate conflicts of interest and inspect, investigate, and discipline NRSROs.

7. Make Establishing a Global Financial Regulatory Floor a U.S. Diplomatic Priority

***Problem with current system*: The globalization of financial markets encourages countries to compete to attract foreign capital by offering increasingly permissive regulatory laws that**

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[100] Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Frank Partnoy, *Assessing the Current Oversight and Operation of Credit Rating Agencies,* 109th Cong., at 5 (Mar. 7, 2006) (online at banking.senate.gov/public/_files/partnoy.pdf).

[101] A recent SEC report acknowledged, "The rating agencies' performance in rating these structured finance products raised questions about the accuracy of their credit ratings generally as well as the integrity of the ratings process as a whole." Summary Report, *supra* note 88, at 2).

[102] Frank Partnoy has suggested linking regulation instead to market-based measures of risk, such as credit spreads or the prices of credit default swaps. Partnoy, *supra* note 100, at 80–81.

[103] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, at §§ 101–109.