

Object-Oriented Regulation – Another Peek at the World When the Crisis is Over

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Originally Published in *Traders Magazine* on October 14, 2008

<http://www.tradersmagazine.com/news/102241-1.html>

Beginning in the 1980s, lawyers for financial institutions argued, at the behest of their clients, for the repeal of the Glass-Steagall Act of 1933. The date of this legislation tells you something. Glass-Steagall was a centerpiece of Depression-era banking reform. Ultimately, the financial services industry had its way.

The Gramm-Leach-Bliley Act of 1999 repealed that part of Glass-Steagall that separated commercial banking from investment banking. In simple terms, investment banks were not permitted to accept deposits, and commercial banks were not permitted to underwrite securities. This functional segregation was intended to reduce speculation, which was widely believed to be the cause of the financial crisis that led to the Great Depression.

Depression-era regulation followed from the design of Depression-era legislation. So, the Securities and Exchange Commission regulated investment banks, while the Federal Reserve Bank regulated commercial banks. The twain rarely met.

Advocates for the repeal of Glass-Steagall touted a concept called “functional regulation.” The idea was that instead of regulating types of institutions, regulators should be responsible for certain functions. So, when a commercial bank was engaging in “securities activities,” the SEC would be their regulator. When an investment bank engaged in “commercial banking activities,” the Fed would be their regulator. While a good idea in principle, battles over turf beggared the concept of functional regulation in application.

Banks never really thought of the SEC as their regulator and complained at every turn to the Fed whenever the big, bad SEC tried to make them do anything. Eventually, it took a second Congressional intervention to produce a mild form of SEC regulation over securities activities conducted by banks. The SEC’s regulation of banks remains tame, to say the least. The resistance of commercial banks to SEC regulation is explained, at least in part, by the view among bank officers that the SEC’s true agenda is to protect investment banks, their clients, from competition.

The Fed was heavily involved sorting out the scandal caused when a rogue Salomon Brothers trader rigged the auction for treasury bonds in 1991. The Fed was also involved in the successful effort to stave off a potential crisis when Long Term Capital failed in 1997. However, Bear Stearns, which was Long Term Capital’s prime broker and therefore had the most at stake, famously rejected the Fed’s attempts to oversee its activities. Until this most recent financial crisis,

investment banks politely showed Fed officials to the door most of the time, and the SEC could be counted on to support that position.

Institutional segregation in the financial services industry had an unfortunate tendency to create political turf and real or imagined efforts to protect it.

With the demise of functional regulation, the question is what will take its place.

There are calls to revive Glass-Steagall. While I was not in favor of its repeal, I think its resurrection would be a mistake. It is usually a bad idea to revive old ideas because, like old lovers, they are never quite the same decades later. Instead, we need a new approach to financial regulation designed to address the highly automated, information-rich environment of the 21st Century global economy.

As it happens, parts of Glass-Steagall remain with us to this day. The Act established the Federal Depositary Insurance Commission (FDIC), which insures bank deposits up to \$100,000. The occasional right-wing proposals to do away with this program have never been taken seriously. Instead, the most recent Bail-Out Plan increased the amount of insurance coverage to \$250,000. We can expect the FDIC to play a prominent role in the unfolding banking maelstrom.

The latest proposals for reform are “objectives-based.” Instead of trying to determine whether a particular financial services business is securities related or banking related, object-oriented regulation is targeted at the essential elements of the business of financial services.

Financial services businesses essentially have the same components. There are marketing activities intended to raise capital for the firm. Fee income is generated by various professional services provided by the firm. Commercial banks, investment banks, insurance companies and funds of every stripe take the money they have received from depositors or investors and seek to make profitable investments. This investment activity increases the supply of money available in the economy.

Fee income is the least risky way to make profits in the financial services industry. It also tends to be the least profitable. Investment activity is the most profitable way to generate income and the most risky. Because investment activity increases the supply of money available in the economy, ultimately there will be a crash when too much money chases too few good investments.

The Fed’s primary mandate is to protect the safety and soundness of banks. To do this, it actively regulates the investment activity of banks, which is primarily a matter of regulating their lending activity through net capital requirements. The Fed does a very good job at managing this task. For one thing, it has some very useful tools at its disposal. It is very actively involved in supervising the financial condition of banks. It can loan them money when things are a bit tight. It can cause bank deposits to be held by another institution when things go downhill. It

can loan money to the acquiring bank to facilitate the takeover. Its capacity to serve as the lender of last resort enables the Fed to defend against circumstances that might cause financial institutions to fail.

The SEC is much less effective when it comes to protecting the safety and soundness of investment banks. It lacks the financial wherewithal to make loans to failing brokerage firms. About all it can do when things go bad is close a firm down, a strategy much too blunt when we are dealing with a large investment bank with global relationships.

On the other hand, the SEC is very good at regulating sales practices. The SEC's primary mandate is to protect the investing public from fraud. For this reason, it is well-situated to regulate markets. Fraud is the single greatest enemy of orderly markets.

The Fed's record of regulating sales practices is weak, at best. Bank salesmen sold sub-prime mortgages to weak credits with reckless abandon, promising the earth and moon and stars. Under similar circumstances, the SEC and FINRA would have been expected to impose fines and other regulatory sanctions. Investor (borrower) alerts would be springing up regularly. Mandated disclosure would be imposed, and supervisory principals would everywhere be clamping down to avoid charges of failure to supervise. Nothing like this level of scrutiny for sales practices exists in the world of banking regulation.

When the crisis is over, we can expect the new order will consist of a more object-oriented form of regulation. The Fed will take over supervision of net capital rules, clearing and settlement. The SEC will supervise markets and sales practices. I think the SEC's mandate will extend to sales of bank loans, insurance products and other financial instruments.

The Fed's mandate should include the regulation of financial derivatives. The SEC's only stab at regulating derivatives has been to impose position limits on options. This form of regulation has not been effective. The Fed is much better positioned to restrain the issuance of derivatives with a view to protecting the economy from excess leverage. The SEC can most usefully regulate the way these instruments are sold in the marketplace.

It is, of course, entirely possible that Congress will decide to create entirely new agencies. There may be too much political baggage for a remodeled SEC and Fed to work together effectively. But, a rose by any other name smells just as sweet, and it seems inevitable to me that financial services will end up being regulated primarily by two agencies – one responsible for sales practices and markets, the other in charge of safety and soundness of financial institutions and controlling the amount of leverage in the economy.

Why two agencies? The lesson learned from the current crisis is that one agency cannot effectively manage both tasks. The SEC effectively regulated sales practices, but failed to defend the solvency of investment banks. The Fed was not effective in regulating sales practices, but has done an impressive job of keeping financial institutions solvent, even those that were not within its administrative jurisdiction.

This glimpse into the future of regulation is not all that different from the Department of Treasury's proposal announced in March. The Treasury's proposal would provide three regulators for the financial services industry responsible for one of three objectives – market stability, safety and soundness, and business conduct. Treasury believed a separate "safety and soundness" regulator was required to deal with institutions that receive government insurance, such as the insurance of deposits under the FDIC. Recent events suggest that the government is implicitly required to guarantee the commitments of most financial institutions, including those for whom there are no explicit government guarantees. So, safety and soundness and market stability are inextricably linked and should be the objectives of a single regulator.

I believe the object-oriented approach to financial services regulation is more likely to succeed than the business segregation imposed by Glass-Steagall. The objective form of regulation does not prevent business from pursuing profitable lines of business, a regulatory strategy that doomed Depression-era regulation. Instead, it requires persons engaging in a financial services business to check in with a regulator to permit the monitoring of their activity.

Will object-oriented regulation succeed? For all of its failures, the fact is that as a people, we are getting better at this. The last credit crisis in this country occurred some eighty years ago, breaking what was then a 10-year cycle. Perhaps this time, we can postpone the next credit crisis for a couple of centuries. By that time, with changes in technology, there may no longer be any banks or broker-dealers to regulate.

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