CFA

Consumer Federation of America

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REFORM OF FINANCIAL MARKETS

THE COLLAPSE OF MARKET FUNDAMENTALISM AND THE FIRST STEPS TO REVITALIZE THE ECONOMY

ISSUE BRIEF

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April 2009

The Context of the Current Crisis

Over the course of the past year, the nation has experienced a collapse of its financial markets that has plunged the real economy into a deep recession. As a subprime mortgage crisis has morphed into a global financial catastrophe, it has become increasingly clear that nothing in recent history comes close to the current situation other than the Great Depression of the 1930s. The crisis is so severe and its onset so (apparently) sudden that almost all analysts have realized this is not a routine downturn in the business cycle, and business as usual responses will be insufficient to solve it. The search for more aggressive policy responses has triggered both a hunt for the root causes of the crisis and growing calls for sweeping reforms of our system of financial regulation.

This paper examines how "market fundamentalism" – the dominant regulatory philosophy of the past three decades – led to the current crisis. The purpose of the paper is to provide a general explanation of the key factors that have caused the failure of market fundamentalism and, based on that analysis, to identify the principles that must be embodied in proposals to repair, reform and rebuild the economy. We organize that analysis around the recommendations of high-profile regulatory reform proposals released in recent months by the Group of Thirty and the Congressional Oversight Panel. While neither proposal is likely to be seen as a perfect embodiment of all public interest group priorities for reform, both recognize the failure to impose effective prudential regulation on financial institutions and products as a root cause of the crisis and both make a strong and compelling case for a dramatic increase in oversight of financial markets. The Group of Thirty report frames the challenge starkly: "How can we restore strong, competitive, innovative financial markets to support global economic growth without once again risking a breakdown in market functioning so severe as to put the world economies at risk" (Group of Thirty, *Financial Reform: A Framework for Financial Stability* (Washington, D.C. January 15, 2009), p. 4.).

This is, in our view, the correct question for policymakers to ask, but it needs to be answered in a comprehensive and rigorous fashion. This paper places the recommendations of the Group of Thirty and the COP in the context of six fundamental flaws that afflict market fundamentalism, as described in Tables ES-1 and ES-2. The overarching conclusion we reach, based on our analysis, is that we do not need a new, New Deal. Nor do we need to resort to some radical, untried experiment to solve our financial problems. Market fundamentalism was the radical experiment that pushed deregulation much too far in the financial sector. To cure its excesses, we need to rediscover the pragmatic, progressive values of the original New Deal. We need to return to the principles and restore the institutions of New Deal prudential regulation.

Table ES--1: Detailed Congressional Oversight Panel Recommendations

Moral Hazard	Information/Accounting	Incentives	Agency	Conflicts of Interest	Unfairness/Inequality
1. Identify and Regulate Financial	3. Shadow Banks	2. Limit Excessive Leverage	5. Reform Executive Pay	6. Reform Credit Rating	4. New System for Mortgage
Institutions that Pose Systemic	Public Reporting	Objectives Based Capital	Tax Incentives	Close Revolving Door	and Consumer Credit
Risk	Positions	Leverage rqts	Asymmetric Pay	Change Fee System	Allow States to Enforce Laws
Systemic Risk Regulator	Transaction	Counter Cyclical Capital	Options	Promote Competition	on National Banks
Authority		Liquidity Rqts	Severance	Impose Liability	Create a Single Federal
Tools	6. Reform Credit Rating		Claw Back		Consumer Credit Regulator
Reporting	Implement Overnight Authority	3. Supervise Shadow System	Corporate Governance		
Heightened Regulation	Registration	Safety Reg.	Strengthen Bd.		
Countercyclical Capital	Recordkeeping	Regulate Activity/Products	Long-Term Focus		
Insurance	Reporting	OTC			
Strict Leverage Ratios	Re-evaluate Models	Clearing House	6. Reform Credit Rating		
Strict Capital Ratios	Assumptions	Margins	Eliminate or Scale		
Limits on Contingent Liability	Embedded Structuring	Mark-to-Market	back NRSRO		
Limits on Off-Balance Sheet		Guaranty Funds	designation		
Caps on Short-Term Debt		Exchange Traded Derivs.	Credit Rating Rev. Brd.		
Caps on Taxpayer Exposure		CEA Contract Rules	ex ante review		
Receivership and Liquidation		Registration	ex post auditing		
Process		Reporting			
		Capital Rqts			
8. Prepare for Next Crisis					
Financial Risk Council		7. Global Regulatory Floor			
Dedicated to Task		Establish Regulatory			
Diverse Points of View		Floors & Harmonize			
Broad Perspective		Coordinate Surveillance			
Multiple Specialized		Strengthen Communications			
Analytic Tools		& Cooperation			
Formal Reporting		Target Systemic			
		Institutions			

Source: Congressional Oversight Panel, *Special Report on Regulatory Reform,* January 29, 2009.

Tablet ES-2: Detailed Group of Thirty Recommendations

	Problems						
	Moral Hazard	Information/Accounting	Incentives	Agency	Conflicts of Interest	Agency	Unfairness
Solutions							
Filling Gaps	1a - "Too Big to Fail" Banks	4a -Registration and Reporting	1b - Capital & Margin Rqts	1b -Ownership Interest	1b - Ban/Control of Comingling	1b -Ownership Interest	
	Single Regulator						
	Size Based Scrutiny	4b - Reporting Rqts	2a - Consolidate Regulation				
	National Limits						
		4b - Disclosure Stds	2b - Non-banks				
	1c - Separation of Banks/Nonbanks						
			3a - Bank-like Mutual Funds				
	3b - Mutual Funds						
	Reorganize	4a - Public Disclosure for Private Pools	4a - Register Private Pools				
	Differentiate						
	Conservative Investment		4c - Regulate Lg Private Pools				
			Capital				
	5a - GSEs		Liquidity				
	Separation		Risk mgmt				
	Public Delimitation						
			4d - Off Shoring				
			Regulation at Business Location				
			6a - Fix regulation				
			Gaps				
			Overlaps				
			Complexity				
			Remove opportunity for arbitrage				
Prudential	7c- Access to Liquidity	8a - International Information Sharing	7a - Central Bank Role in Stability				
Regulation			Crisis and Expansion				
	7d - Emergency Lending Authority	8b - Gather Information on Leverage	Participation in Governance				
			Input into key regulations				
	7e - Limitations on Liquidity Actions		Supervisory role in				
			lg firms, payment and clearing				
			8a - Offshoring				
			Delineation of Responsibilities				
			Close Gaps				
			Raise Standards				
			Intl Standards				
			8b Define Leverage				
			8c - Formal Regional Mechanisms				

	Problems						
	Moral Hazard	Information/Accounting	Regulation of Incentives	Agency	Conflicts of Interest	Agency	Unfairness
	Problems						
	Moral Hazard	Information/Accounting	Incentives	Agency	Conflicts of Interest	Agency	
Solutions							
Standards			Tolerance	Compensation	Indep. Board Members	Compensation	
		11c - Liquidity Disclosure Stds	Profile	Risk Mgmt Policies		Risk Mgmt Policies	
					9c - Independence		
		12a - Reevaluate Fair Value	9e - Periodic Review of Profiles		Auditing		
					Risk Mgmt		
		12c- Credit Loss Reserves Principles	9f - Assessment of Counterparies				
					12b - Accounting Stds		
		12c - Transparency of Reserve Determination	9g - Accept CRMPG and IIF		Reevaluate Fair Value		
			10a - Raise Capitalization Stds				
			10b - Upper End of Guidance				
			10c- Reevaluate Definition of Capital				
			11a - Diversified Mix &				
			Cushion of Liquidity				
			11b - Liquidity Stds				
Transparency	16a - Closing of Regulated Banks	13a -Securitized & Structured Assets	13a -Securitized/Structures' Assets	13b - Securitization	14a - Indep. Internal Risk Rating	13b - Securitization	
		Disclosure = Securities	Regulatory Stds = Securities	Retain Credit Risk		Retain Credit Risk	
	16a - Non-Depository Insts				14c - Payment to Align Incentives		
	Resolution of Failed	13c - Off Balance Sheet Vehicles	14b - Rating Agencies				
	Regulated only		Accountability for Quality				
	Establish Regulator as Receiver	15b - Share Information on CS=DS and OTC	More Robust Valuation				
		17a - Asset Backed Products	15a - Regulate OTC Derivatives				
	16d- Special Treatment of Contract	Determine Disclosure Info					
			17b - Structured Product				
		18 - Evaluate Higher Level of Transparency	Regulated Disclosure				

Source: Group of Thirty, ***Financial Reform: A Framework for Financial Stability*** **(Washington, D.C. January 15, 2009)**

The administration has begun to articulate its proposal for regulatory reform of financial markets, and the initial signs are encouraging. They have adopted an appropriately broad view of the crisis. In congressional testimony to introduce the first elements of the plan, Treasury Secretary Timothy Geithner said, for example, that "our system failed in basic fundamental ways." (Testimony of U.S. Secretary of Treasury Timothy F. Geithner before the Committee on Financial Services, U.S. House of Representatives, March 26, 2009.) In describing that failure, he cited many of the individual problems we analyze in this report:

> The system proved too unstable and fragile, subject to significant crises every few years … Innovation and complexity overwhelmed the checks and balances in the system. Compensation practices rewarded short-term profits over long-term return … The huge apparent returns to financial activity attracted fraud on a dramatic scale. Large amounts of leverage and risk were created both within and outside the regulated part of the financial system.

"To address this will require comprehensive reform. Not modest repairs at the margin, but new rules of the game," he added.

Ultimately, Geithner said, the administration's regulatory reform plan will cover four broad areas: systemic risk, consumer and investor protection, eliminating gaps in our regulatory structure, and international coordination. This list of priorities indicates a willingness to define the solution broadly. Although the administration has pledged to move on its broader agenda in the near future, its initial recommendations cover the area of systemic risk and this is reflected in the detail provided in Table ES-3.

The Rise and Fall of Market Fundamentalism

Market fundamentalism had its symbolic birth when former President Ronald Reagan famously declared in his first inaugural address that, "Government is not the solution to our problems. Government is the problem." The term market fundamentalism, which has previously been used by Nobel Laureate economist Joseph Stiglitz, refers to an ideology that places an almost religious faith in the workings of the free market. The cornerstone of this philosophy is the efficient market hypothesis. This is the belief that the pursuit of private interest through unregulated markets is all we need to promote the public good, because markets inevitably create efficiency, growth and stability. The efficient market hypothesis has proven to be a fallacy, as have two other tenets of market fundamentalism – the "trickle down" economics hypothesis, which claimed that inequality does not matter, and the " less government the better hypothesis," that claimed that anything that government did was worse than doing nothing.

As long as the institutional structures and prevailing philosophy of the New Deal

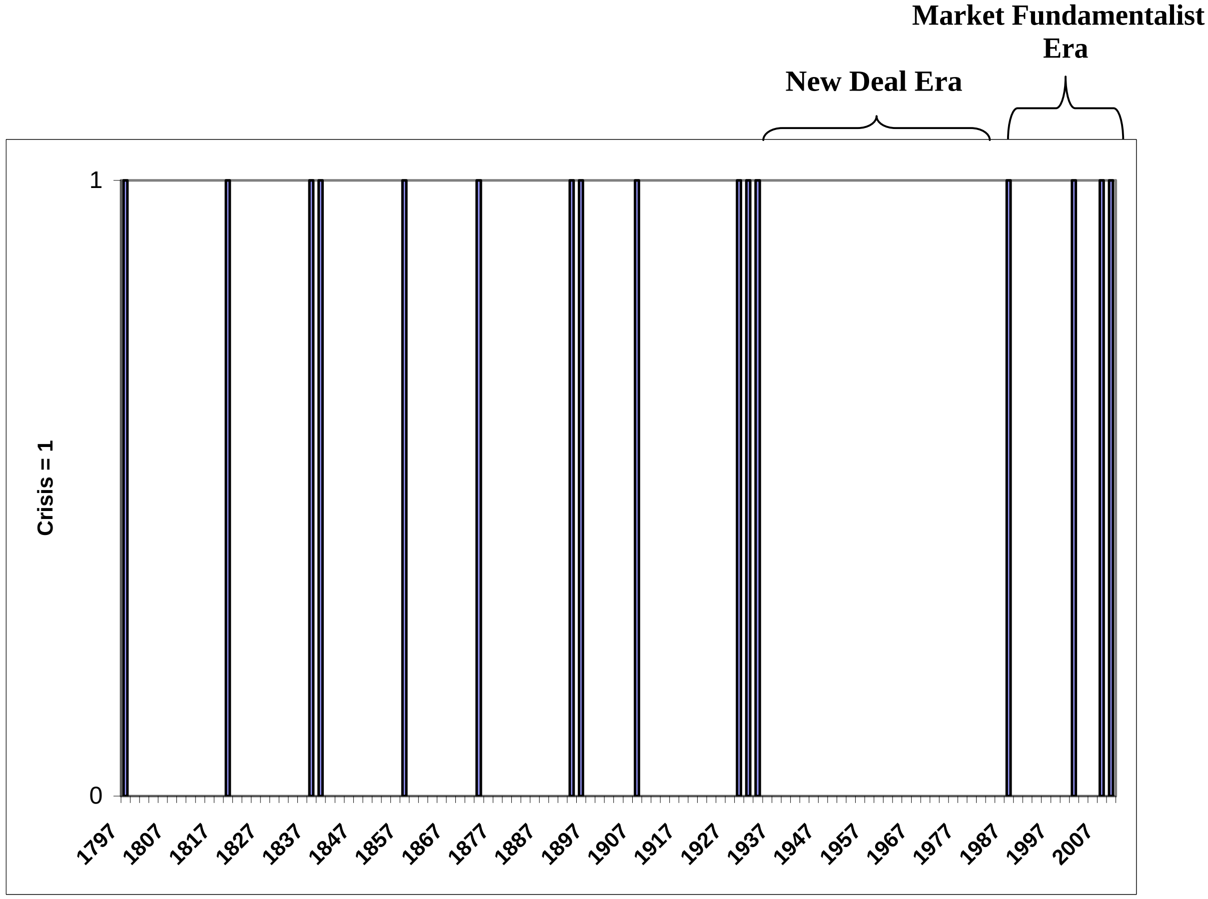
Table ES--3: Initial Proposals of the Obama Administration

Moral Hazard	Information/Accounting	Regulation of Incentives	Agency	Conflicts of Interest	Unfairness/Inequality
Not Just Institutions, but he System	SEC Disclosure for Registered	Leveraged Private Investment	Executive Compensation		Strengthen Consumer and Investor
	Hedge Funds	Register with SEC	Improved risk Mgmt.		Protection
Single Entity			Long term focus		
		Do Not Ban Products			Federal Product Safety Bd?
Risk Sensitive Prudential Reg.					
Counter Cyclical Rqts.		Money Market Funds			
Size/Risk sensitive		SEC reduce risk of rapid			
capital		withdrawal			
reserves					
liquidity		Hedge Funds and Private Pools			
		Close gaps			
Conservative Capital		Register at SEC if big			
Further into the tails of outcomes		Report to asses threat			
Liquidity constraints		shared with regulator			
Aggregate counterparty risk					
		CDS and OTC Derivatives			
SIF Defined		Supervise SIF scale firms			
Size		Standardized through clearing			
Interdependence		Supervise clearing			
Leverage (include off balance sheet)		Greater use of exchanges			
Reliance on short term funding		Nonstandardized			
Importance as source of credit		Document			
		Confirm trades, netting,			
Resolution Mechanism		collateral margin, &			
FDIC Process for New Institutions		close-out practices			
Institution covered include					
Banks and Thrift Holding Cos		Intl. Coordination			
Insurance Cos		Prudential Supervision			
Futures Merchants		Address Tax Havens & Money			
Any other SIF		Laundering			

Source: Testimony of U.S. Secretary of Treasury Timothy F. Geithner before the Committee on Financial Services, U.S. House of Representatives, March 26, 2009

remained in place in the financial sector, financial crises remained manageable, and the country experienced a prolonged period of economic growth and financial stability. (See Figure ES-1) In contrast, during the past 30 years in which the market fundamentalist philosophy has prevailed, we have witnessed a series of domestic economic crises and financial meltdowns. Beginning with the S&L crisis of the 1980s, these have included the derivatives crisis of 1994, the collapse of a famous hedge fund, Long Term Capital Management, the tech stock bubble, the Enron fiasco and accompanying accounting scandals, the energy speculation bubble, and the housing bubble. There have also been three recessions and a series of foreign financial and economic crises. In short, barely a year went by in which one could not find a major market failure that should have raised loud alarms about the economic structure that we were building in the world. This time, things are much worse, and policymakers are forced to pay attention.

Figure ES-1: History of Major Domestic Financial Crises



Sources: Congressional Oversight Panel, *Special Report on Regulatory Reform,* January 29, 2009.

If President Reagan's inauguration marked the symbolic ascendance of market fundamentalism, ironically, its collapse was symbolically announced last October by former

Federal Reserve Chairman Alan Greenspan, one of the leading architects and advocates of deregulation of financial markets. In congressional testimony, Greenspan, admitted to a major flaw in the theory.

> Those of us who looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets state of balance…
>
> If it fails, as occurred this year, market stability is undermined…
> I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms (U.S. House of Representatives, Committee on Oversight and Government Reform, October 23, 2008)

Public interest advocates have long held that the pursuit of private profits is not synonymous with the public good. The constant stream of crises and meltdowns during the ascendance of market fundamentalism provided more than adequate fuel to sustain this belief. In his remarkable admission, Greenspan went one step further and acknowledged, in blunter and clearer language than has been his practice, that the pursuit of private profit is not necessarily synonymous with the private good.

The Flaws in Market Fundamentalism

Left to its own devices, the market suffers from inherent or endemic flaws as a result of which it fails to consistently achieve its primary function of efficiently allocating resources to uses. These flaws are highly inter-connected, so one could draw the lines and distinctions between problems in various ways. The important lesson is that there is a nexus of problems that plagues market fundamentalism in the financial sector and leads to its failure to execute its proper function in the economy.

<u>Moral Hazard</u>: In the finance sector, there has long been a tendency to shift costs and risks onto the backs of taxpayers, where the government guarantees the ultimate soundness of financial institutions, either directly through insurance, or indirectly, by conceding that some institutions are "too big to fail." The shift of risk is highly visible where the government acts as insurer, and the counterbalance to that risk was supposed to be vigorous government regulation to constrain risky behavior. But market fundamentalism led to weak government oversight even at insured institutions. Financial institutions outside the insurance system were even less constrained in the risks they could assume. As a result, the government has been driven to bail out not only banks and the government sponsored enterprises, Fannie Mae and Freddie Mac, but also investment banks and insurer AIG. What was once an abstract threat – that financial institutions would take irresponsible risks in the confidence that the government would bail them out – has become a pressing reality.

Transparency and Asymmetric Information: The second flaw that receives a great deal of attention in discussions of the current financial crisis is information transparency. The availability of information is central to the operation of efficient markets. Lack of transparency makes it difficult to evaluate risk and achieve efficient outcomes, while asymmetry of information between management, stockholders and the public provides an open invitation for mischief. These problems have been manifest in the current crisis in a host of ways, including collateralized debt obligations so complex as to be completely opaque even to many who bought and sold them; financial institutions who used accounting maneuvers to move risky assets off their balance sheet in ways that were supposed to be outlawed after the Enron scandal; and intricate inter-connections of institutions through over-the-counter derivatives transactions that left participants in the dark about the nature and scope of counter-party risk to which they were exposed.

Key players who had critical roles in the information chain had massive conflicts of interest that either blinded them to risks or made them reluctant to convey that information to other market participants. As a result, the quality of information was abysmal. This includes credit rating agencies, whose AAA ratings were essential to creating a market for mortgage-backed securities. Paid by issuers, the ratings agencies' profitability depended on their ability to win market share in the highly lucrative business of rating structured finance deals, and their ability to win that business too often depended on the "flexibility" of their ratings. Investment bankers, meanwhile, were responsible both for ensuring that credit rating agencies received complete and accurate information regarding the securities they were to rate and that investors received full and fair disclosure regarding the deal. But the massive fees they earned underwriting the securities left them with little incentive other than the public interest to fulfill their information responsibilities diligently.

Perverse Incentives: Market fundamentalism has a pervasive incentive problem that creates an engine of instability in the structure/conduct heart of the unregulated financial market. This was evident in the current crisis, where a daisy chain of conflict-ridden market participants spread the risks from unsound mortgage loans into every corner of the global financial markets. As fees from making deals became a major source of income, the quality of the deals mattered less and less. After all, the deals could always be sold by conflict-ridden brokers, supported by loans from conflict-ridden banks, securitized by conflict-ridden investment banks, rated by conflict-ridden credit rating agencies, and moved off the balance sheets so that more deals could be made and more fees earned. As long as more money could be pulled in, the day of reckoning could be pushed off. The structure of income and compensation created a perverse incentive to pump up fees and bonuses, with little regard to the quality of the underlying assets and loans.

Agency: The separation of ownership and control has long been recognized as a social problem for the capitalist economy, but the incentive structures of market fundamentalism make it urgent. Stiglitz has described a powerful interaction between information, agency, incentive structures and conflicts of interest. Because of imperfect information, it is often difficult to make sure that an agent does what he is supposed to do. Because of the failure to align incentives, it is often the case that he does not.

The problems of agency and perverse incentives intersect in a highly visible issue in the current context – executive compensation. Compensation packages for financial industry executives not only increased dramatically in recent years, but also took on a structure that introduced short-term bias in business decision-making. Hedge fund manager David Einhorn described this phenomenon in a recent speech on "Private Profit and Socialized Risk." Noting that investment banks pay out 50 percent of revenues as compensation, he said, "the management of the investment banks did exactly what they were incentivized to do: maximize employee compensation … So, more leverage means more revenues, which means more compensation. In the good times, once they pay out the compensation, overhead and taxes, only a fraction of the incremental revenues fall to the bottom line for shareholders." In the bad times, as we have recently seen, the results for shareholders are cataclysmic.

<u>Conflicts of Interest</u>: Conflicts of interest pervade the financial system. We have already mentioned the key role that conflicts at credit rating agencies and investment banks played in bringing about the current crisis through its impact on information. However, conflicts of interest can and do take many other forms as well. When, for example, a single entity owns both an insured business (e.g. a commercial bank) and an uninsured business (an investment bank), or both regulated and unregulated subsidiaries that deal with each other, there is a powerful conflict of interest. Profit can be increased by having the insured (regulated) entity, which is not supposed to get into risky lines of business, subsidize the uninsured (unregulated) ventures that do get into riskier businesses, with imprudent loans. Or unregulated entities (such as off-balance sheet investment vehicles) can be used to hide risks assumed by the regulated entity (bank) in order to evade capital requirements designed to protect against risks to taxpayers.

At the extreme, where agents not only pursue their interests at the expense of shareholders and the public, but also do so illegally, conflicts of interest become fraud. Fraud is not unique to market fundamentalism, but the institutional structure creates a fertile field for an endemic fraud problem. High stakes, lax oversight, creative accounting and a short-term perspective are conducive to fraud. In an environment that emphasizes short-term stock market returns and allows risk takers to take out earnings quickly, practices degenerate. As the bad actors get their short-term rewards, the good actors become desperate to keep up. In fact, given the structural conduciveness to fraud and the structurally induced race to the bottom in ethics, it is fair to argue that market fundamentalism has a uniquely endemic fraud/abuse problem.

<u>Unfairness/Inequality</u>: The five flaws described above have all been recognized as creating a potential for market failures in unregulated markets. In its report on financial regulatory reform, the Congressional Oversight Panel adds a sixth – unfairness. Unfairness

in transactions, the COP argues, can starve the system of resources, raising costs and restricting activity. It describes two categories of problems, outright deception and fraud on the one hand and a more subtle problem that exists when parties to a transaction are unfairly matched. In addition to threatening the flow of resources into the system, unfairness in transactions can result in misallocation of resources, as lenders take advantage of overmatched borrowers, for example.

This broader conceptualization of the importance of unfairness/inequality as a supply-side issue fits the current crisis in another sense, which is a demand side problem. The severe increase in inequality of income and resources that took place during the reign of market fundamentalism resulted in a failure of incomes to keep up with the rapid expansion of the production capacity of the economy. The rising cost of necessities – housing, education, health care, and energy – put severe stress on household budgets, causing them to plunge into debt to maintain their standard of living. Savings are too low, and concentrated wealth creates rampant speculation rather than productive investment in the real economy.

Restoring Prudential Oversight over Financial Markets

In recent months, two high profile reports have been issued that reflect the immense scope of regulatory reform that is needed to address the collapse of market fundamentalism in the financial sector. In January, the Group of Thirty, a prestigious group of international financial and economic experts, issued a report calling for a dramatic increase in regulatory oversight of financial markets, including more than four dozen specific principles intended to achieve four core recommendations: 1) eliminating gaps and weaknesses in coverage of prudential regulation and supervision so that all systemically significant financial institutions are subject to appropriate oversight; 2) improving the quality and effectiveness of prudential regulation and supervision; 3) strengthening institutional policies and standards, particularly with regard to corporate governance, risk management, capital, and liquidity; and 4) making financial markets more transparent, with better aligned risk and prudential incentives.

Two weeks later, the Congressional Oversight Panel, established by Congress to oversee the Troubled Asset Relief Program, issued its own report with a similar thrust. The COP Report organized its recommendations into eight broad categories covering much the same ground as the Group of Thirty: 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; 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; and 8) plan for the next crisis.

This report analyzes those recommendations in light of how they address the flaws previously identified with market fundamentalism.

Moral Hazard: The COP makes two broad recommendations on moral hazard. First, it calls for a systemic risk regulator with adequate authority and tools to identify and regulate systemic risk. It then identifies numerous specific policies that are intended to reduce systemic risk. The Group of Thirty recommendations on moral hazard identify the products and institutions that put the taxpayer at risk and propose a variety of mechanisms to reduce the exposure to risk through federal backing of institutions. In some cases, it advocates banning relationships that create the moral hazard. In others, it would place limits on the extent of exposure by regulating the product or the institution. Interestingly, it also contemplates limiting the size of institutions that are insured and advocates a sliding scale of reserves to reduce the exposure of the public. One of the interesting new wrinkles in thinking about dealing with systemic risk in both sets of recommendations is the recognition that more attention needs to be devoted to setting up procedures for liquidation of loans (and institutions) in default.

Both also declare a need to prepare for the next crisis. The COP proposes to do so by creating a new entity dedicated to the task of assessing systemic risks to the financial system. It recommends that this entity be made up of diverse points of view, take a broad perspective on potential threats, use multiple, sophisticated modeling techniques, and report to the Congress on its findings. In contrast, the Group of Thirty recommends formalizing and circumscribing the new role for the central bank in ensuring stability. This issue of where that responsibility should reside could prove controversial, with some arguing as the Group of Thirty does that the Fed should play this role and others arguing just as vigorously that the Fed is ill-suited to this function. Despite the brewing debate on this question of jurisdiction, the concept of enhanced systemic risk regulation has broad support, and the need for better preparation for future crises is an important area of agreement.

Information: The COP report offers policy recommendations to improve information in two areas – shadow banking and credit rating agencies. For shadow banking, public reporting of positions and transactions is recommended. Since credit rating provides such a vital function, the COP recommends an oversight authority and a re-evaluation of their models. The Group of Thirty also calls for greater transparency and higher quality of information and accounting, including by making information disclosure a requirement to offer products both to the public and in the currently unregulated private markets.

Perverse Incentives: The COP report identifies three areas of policy to address perverse incentives – excessive leverage, shadow banking and international regulation. The report recommends four policies to limit leverage, and it proposes to extend regulation to over-the-counter markets and pull derivatives into exchanges, where traditional tools of prudential regulation would apply. The Group of Thirty recommends that the full range of classic instruments of prudential regulation of financial institutions be strengthened. This includes defining capital and setting strong capital and margin requirements as well as enhanced monitoring of the status of institutions with a new view of risk, leverage and liquidity. It is similarly comprehensive and detailed in its call to extend regulation to the shadow banks and bank-like institutions that have come to play such a large role in financial markets.

The perverse incentive in the international arena is forum shopping for the least regulated haven, which creates a race to the bottom for regulation. The COP proposes to negotiate a regulatory floor, harmonize regulation across nations, and improve communications, cooperation and surveillance, focusing on systemic risks. The Group of Thirty has a similar call for international cooperation, with less detail.

Agency: The COP report identifies two problems of agency that afflicted the financial system as configured in recent years: executive compensation and the role of credit rating agencies. It suggests that the agency problem that afflicts credit rating agencies could be addressed by creating a public entity that would have to sign off on any rating before it took on regulatory significance. The COP calls for reform of executive compensation to better align executive incentives and actions with the long-term interests of shareholders, and it identifies tax incentives, asymmetric pay and clawback of pay as areas for policy improvement. Both the COP and the Group of Thirty also identify corporate governance as an area for institutional improvements, particularly with regard to executive compensation and risk management. In addition, the Group of Thirty recommends that originators of loans be required to retain substantial ownership interest in those assets.

Conflicts of Interest: The COP report focuses its conflict of interest recommendations on the credit rating agencies, advocating that the revolving door between the industry and the agencies should be closed, the payment system altered and liability imposed. It also suggests policies to increase competition. While the perverse incentives of conflicted rating agencies are given explicit attention in the Group of Thirty Report, it discusses a broader range of policy responses. Reducing conflicts of interest is handled in the Group of Thirty Report much like the reduction of moral hazard, with a mix of bans and regulatory oversight intended to reduce the problem. Comingling of regulated and unregulated business is discouraged. Conflict of interest is also addressed by creation of independent internal and external governance and evaluation of risk.

Unfairness and Inequality: The COP recommendations focus on the endemic problem of unfairness and inequality in two major areas – mortgage and consumer credit. Here the mismatch is severe, and the report lists a variety of conditions and exploitative practices that were common in the mortgage market. In response, the COP proposes to increase regulation by allowing state consumer protection laws to apply to national banks and by creating a single federal regulator for consumer credit covering both mortgage and consumer credit.

Conclusion

Effective reform must challenge the market fundamentalist ideology or it will fall far short of accomplishing what is needed to repair the system. While each has its flaws, both the COP report and the Group of Thirty recommendations pass that test, proposing a set of reforms designed to restore meaningful prudential regulation across the financial markets. As early reaction to these proposals has made clear, however, the supporters of market fundamentalism will not easily accept defeat. Already they are attempting to fight by distracting from the real causes of the crisis and mischaracterizing the reforms proposed as socialism. The coming policy debate is not a debate between capitalism and socialism, however, but between a pragmatic, progressive approach to capitalism that was followed in the United States for half a century beginning with the New Deal and the radical market fundamentalist approach to capitalism pursued for the past 30 years, which has collapsed in an economic meltdown of historic proportions.

The debate will be shaped by two tendencies. One is the tendency to defend the failing system and to blame its failure on things other than its fundamental flaws in order to limit the extent of change. This approach has already emerged in some policy proposals of financial sector lobbyists and is clearly articulated in the additional views expressed by the two Republican members of the COP. The second tendency, also already on display across the ideological spectrum, is the desire to affix blame. Blame is cathartic, but not very productive. Anger about the problem does not immediately translate into sound thinking about solutions. At this point, it does not matter who gets the blame; the important thing is that we properly identify what to blame them for. After thirty years of a dominant ideology, thinking clearly and changing direction towards more and better regulation is a challenge for the whole society, but the direction in which the nation must go is clear.

It is time for us to abandon the market fundamentalist view that sees regulation as the *ex post* clean up after the occasional market failure, and to return to the New Deal view which understood that regulation is the *ex ante* prophylaxis to prevent market failure. We must restore the function and effectiveness of institutions of prudential regulation along the lines of the successful structure that the New Deal constructed.

Because of the nature of the current crisis, there is a natural tendency to move from the emergency repair of the system to focus on how to resolve or cushion the collapse of financial markets. Ultimately, however, the threat of collapse of a systemically significant financial institution is not the only problem that afflicts financial markets. The comprehensive view of systemic risk taken by the administration must be applied to the other areas where regulatory reform is needs. Reforming the financial system to ensure it plays its proper role in our economy will not be complete or effective until the Congress adopts and the administration implements policies to prevent excessive risk taking, perverse compensation schemes, and conflicts of interest more broadly and to provide much greater transparency and fairness for investors, consumers and regulators in the financial markets. The Administration has promised to move on to these issues in the weeks and months ahead.

This paper provides the analytic framework for understanding why a comprehensive solution is necessary to repair the financial system in the United States.