Consumer Federation of America

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Contact:
Mark Cooper, 301-384-2204
Barbara Roper, 719-543-9468

CFA ANALYSIS OF FINANCIAL CRISIS DOCUMENTS CAUSES DEMONSTRATES NEED FOR COMPREHENSIVE REFORMS

With regulatory reform plans beginning to take shape in the Administration and on the Hill, the Consumer Federation of America (CFA) released a comprehensive analysis of the current financial crisis that challenges Congress and the Administration to adopt a broad and thorough reform of the financial sector. The 100-page report, entitled *Reform of Financial Markets: The Collapse of Market Fundamentalism and the First Steps to Revitalize the Economy*, provides a rigorous framework for understanding why a comprehensive reform plan is needed to ensure effective prudential regulation.

Using the report as a template, co-authors Mark Cooper, CFA Research Director, and Barbara Roper, CFA Director of Investor Protection, have analyzed the proposal the Administration has begun to articulate for regulatory reform of financial markets and found the initial signs to be encouraging.

"In their initial proposal the Administration has adopted an appropriately broad view of the crisis and a similarly broad view of the solution," Cooper said.

In congressional testimony last week to introduce the first elements of the plan, Treasury Secretary Timothy Geithner said the plan will cover four broad areas: systemic risk, consumer and investor protection, eliminating gaps in our regulatory structure, and international coordination. Although the Administration has pledged to move on its broader agenda in the near future, its initial recommendations cover the area of systemic risk. In this category, the Administration includes creating tools to identify and mitigate systemic risks and to protect the financial system from the failure of systemically important financial institutions.

"Their overall approach to systemic risk regulation – controlling certain risks, improving institutions' ability to withstand shocks, and, should preventive efforts fail, allowing for the orderly failure of non-bank financial institutions – is the right one," Roper said, "though its ultimate success or failure will depend on the details of its implementation." Those details are still to be worked out between Congress and the Administration.

While it is natural to move from the emergency intervention, to prop up the system, to a focus on how to resolve the failure of large financial institutions without causing the collapse of financial markets, the threat of collapse of a systemically significant financial institution is not the only problem that afflicts financial markets.

"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, broader policies to prevent excessive risk taking, perverse compensation schemes, and conflicts of interest. In addition, there must be much greater transparency and fairness for investors, consumers and regulators in the financial markets," Cooper said. "The Administration has promised to move on to these issues in the weeks and months ahead. We hope the Administration takes a similarly serious and comprehensive approach when it does so."

Although the Administration has acknowledged the need for comprehensive reform, others continue to defend deregulation, look to the market for solutions, and try to limit the scope of reform.

"Our analysis shows that defenders of deregulation who are trying to restrict the extent of regulatory reform have made three incorrect assumptions about the nature of the failure of financial markets – misrepresentation of the causes of the crisis, underestimation of the magnitude of the problem and overestimation of the ability of the financial markets to correct themselves," Cooper said.

"We have identified six basic imperfections in financial markets – moral hazard, asymmetric information exacerbated by a lack of transparency, perverse incentives, agency, conflicts of interest and unfairness – that underlie the current crisis, all of which must be addressed if we are to restore the safety and soundness of the financial system," he added.

By carefully defining each of the flaws in financial markets, showing their interconnection with examples from the past decade and examining their impact on market performance, the report shows that the passage of the Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley) and the Commodity Futures Modernization Act of 2000 instantaneously destabilized the domestic financial sector. Lax enforcement of the regulation that remained in place and overreliance on self-regulation compounded the problem and literally let the large banks and the shadow banking system run wild.

The report uses recommendations of the Congressional Oversight Panel and the Group of Thirty as a starting point for analyzing proposed reforms, but points out that neither provides a comprehensive, rigorous framework for understanding why all of their recommendations, and then some, are needed to ensure effective prudential regulation. The report also uses a recent analysis from the Brookings Institution to show how timid recommendations for regulatory reform fail to address the full scope of the underlying problems in unregulated financial markets.

The report concludes that dismantling the institutions of prudential regulation created by the New Deal was a huge mistake and recommends that oversight of financial markets must return to the pragmatic, progressive values and principles on which New Deal regulation was based.

"If policymakers do not admit or comprehend the pervasive and deep-seated flaws in financial markets, they will fail miserably in their efforts to reform regulation, setting the stage for repeated crises and scandals," Roper said. "While some members of Congress and the Administration appear to recognize that fact, others continue to argue against regulation as a solution. More than any single policy or practice, that anti-regulatory bias among regulators and legislators is what needs to change if the goal is to better protect consumers and investors and restore the health and integrity of our financial markets."

The full report is available at: http://consumerfed.org/pdfs/FinancialMarketReformReport.pdf

An issue brief is available at http://consumerfed.org/pdfs/FinancialMarketReformIssueBrief.pdf

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