The Sentinel:

Improving the Governance of Financial Regulation

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Abstract:

Financial regulators and politicians unsuccessfully maintained the safety and soundness of the U.S. financial system not only because they lacked the proper tools but also because they lacked the proper incentives. While filling regulatory gaps and improving supervisory tools are worthwhile reforms, they do not address the core governance failure – the unwillingness of the policy apparatus to adapt to a dynamic, innovating financial system and act in the best interests of the public. I propose an auxiliary institution to act as a sentinel on behalf of the public to improve the design, interpretation, and implementation of financial regulations.

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A dependence on the people is, no doubt, the primary control on the government; but experience has taught mankind the necessity of auxiliary precautions.

James Madison, Federalist 51, 1788

According to the precepts of a representative democracy, the people elect representatives who both enact financial regulations and select financial regulators, who interpret and apply the regulations. If regulators perform poorly, elected representatives replace them. If elected representatives enact harmful policies or select unsuitable regulators, the public elects new ones. According to these principles, oversight by the people motivates elected officials and regulators to act on behalf of the public, not on behalf of narrow, albeit powerful, special interests.

Experience, however, plainly shows the practical limitations of achieving these democratic ideals, especially as regards to the governance of financial regulation. First and foremost, it is exceptionally difficult for the public to obtain, process, and evaluate information on the enactment, implementation, and effects of financial regulations. Second, financial institutions directly pressure and lobby elected officials and regulators, breaking the line of influence running from the public through elected representatives to the execution of financial policies. In particular, the financial sector is a large contributor to political campaigns and many senior regulators use the revolving door by moving from the financial sector into public office and then returning to private financial institutions. Third, a major financial regulatory institution -- the Federal Reserve – is largely independent of the government and hence partially removed from public oversight. While there are good reasons for having highly-skilled individuals with private sector expertise regulate the financial sector and for creating an independent central bank, there are similarly good reasons for supplementing the public's ability to accurately evaluate and effectively shape the design and implementation of financial sector policies.

Although James Madison viewed people as the primarily sentinel over the government, he recognized that history demonstrates the need for "auxiliary precautions" due to the realities of human nature: Officials sometimes use the coercive power of their positions to achieve private objectives that conflict with the goals of the public. Building on Montesquieu (1748), Madison argued that, "ambition must be made to counteract ambition," so that contending institutions scrutinize and compete with each other. These tensions and rivalries not only limit the concentration and abuse of power; they also enhance the proper design and implementation of policies.

The primary objective of this paper is to argue that the financial regulatory governance system failed to act in the public interest not only because regulators lacked the proper tools but because they lacked the proper incentives. Yes, there were regulatory gaps. But, the crisis, and in particular most certainly its severity, was not an inexorable event. Prudent, reasonable observers could have – and did – recognize that official policies had created perverse incentives that undermined sound financial intermediation. In particular, the key regulatory authorities themselves knew that their policies were distorting the sound allocation of capital and yet chose not to reform their policies. The failure of the governance system – the system associated with evaluating, reforming, and implementing financial policies – played a starring role in causing the crisis.

In discussing deficiencies in the governance of financial regulation, I stress the fatal inconsistency between a dynamic financial sector and a regulatory system that lacked the incentives to adapt appropriately to financial innovation. Financial innovations, such as securitization, collateralized debt obligations, and credit default swaps, could have had primarily positive effects on the lives of most citizens. Yet, the inability, or unwillingness, of the apparatus

overseeing financial regulation to adapt to changing conditions allowed these financial innovations to become malignant tools of financial destruction. A more publicly responsible -- and responsive and accountable-- regulatory system could have captured the benefits, while avoiding the pain, associated with these new financial tools.

This conclusion – that governance, not simply specific regulations, contributed to the crisis – has material implications for reforming financial regulation. There are several policy proposals to reduce regulatory gaps, develop better crisis management tools, and consolidate the regulation of all systemically important institutions in the Federal Reserve. Yet, if technical glitches and regulatory gaps played only a partial role in fostering the crisis, then these proposed reforms represent only a partial and thus incomplete step in establishing a stable financial system that promotes economic growth and expands economic opportunities. This is not an argument against filling regulatory gaps. It is an argument for improving the governance of financial regulation. It is an argument for Madisonian institutions that promote transparency, informed debate, and the design of socially beneficial policies.

The second objective of the paper is to propose a sentinel -- an auxiliary institution -- for improving the design, reform, and implementation of financial regulations in a more dynamic manner, including regulations associated with the corporate governance of financial institutions. The sole power of this new "Financial Regulatory Commission" (FRC) would be to acquire any information necessary for evaluating the state of financial regulation as the financial marketplace changes over time. The sole responsibility would be to deliver an annual report to Congress assessing the impact of financial regulations on the public. The senior members of the FRC would be appointed by the President and confirmed by the Senate for staggered and sufficiently long terms, as with the Federal Reserve, to limit political influence. Moreover, senior members

of the FRC would be prohibited from receiving compensation from the financial services industry after completing their public service to limit conflicts of interest. In return, FRC staff would be compensated at market terms to attract individuals capable of evaluating the full array of financial sector policies affecting the economy. The goal is to create an institution in which the personal motives, ambitions, and prestige of its employees are inextricably connected to accurately assessing the impact of financial regulations on the public.

As a sentinel over financial regulations, the FRC would improve the entire apparatus for writing, enacting, adapting, and implementing financial regulations. As an extra group of informed, prying eyes, the FRC would reduce the ability of regulators to obfuscate regulatory actions and would instead make regulators more accountable for the societal repercussions of their actions. As an additional group of experts reviewing and reporting on financial regulations, the FRC would reduce the probability and costliness of regulatory mistakes and supervisory failures. As a prominent institution, the FRC's reports to Congress would help reduce the influence of special interests on the public's representatives. As an entity whose sole objective is to evaluate the state of financial regulation from the perspective of the public, the FRC would help inform the public and thereby augment public influence over financial regulations.

Given the existing myriad of regulatory agencies, quasi-regulatory bodies, and other oversight entities, do we really need another one? The crucial answer is that no other existing entity currently has the incentives, power, or capabilities to perform the FRC's role as a public sentinel over the full constellation of financial sector policies. Besides the natural difficulties of having the Federal Reserve, Securities and Exchange Commission, and other agencies conduct self-evaluations, the internal inspector general departments of these agencies do not have the broad mandate to assess how the complex matrix of financial policies across many regulatory

bodies shape the incentives of financial market participants. Moreover, the FRC needs (1) the power to demand information from private institutions and regulatory bodies, (2) a staff with expertise in banking, securities markets, corporate finance, regulation, the law, and financial economics that has both an ongoing commitment to evaluating financial policies and the professional stature to confront powerful private institutions, regulatory bodies, and Congress itself, and (3) an explicit Congressional mandate to evaluate how the full array of financial regulations and policies affect the incentives of financial market participants in particular and the economy in general. Under various conditions, however, an FRC-type sentinel would fit comfortably within the general designs of the General Accounting Office as discussed below.

The FRC proposal will not eliminate financial and regulatory malfunctions since there might be collective mistakes by the FRC, the Federal Reserve, SEC, etc. But, the FRC fits comfortably within and should help improve upon the successful U.S. institutional template of checks and balances. In this case, rather than checking power with power as advocated by Madison, the potent influences of transparency and independent assessments will boost the likelihood that the design and execution of financial regulations reflect the public interest. The goal is to improve a system that has not been functioning well for far too long using methods that are consistent with the cultural and institutional norms of our country.

Two premises are interwoven throughout my analysis. First, financial innovation has played a prominent role in fostering entrepreneurship, accelerating long-run economic growth, reducing poverty, and expanding economic opportunities for several thousand years. While inconsistencies between financial innovation and regulatory stagnation helped produce the current crisis and its severity, future reforms should be geared toward developing a regulatory system that allows financial entrepreneurs to innovate while maintaining the safety and integrity

of the system. While several distortions encouraged destabilizing financial inventions that spurred the current crisis, we should not forget the beneficial effects of a vibrant financial system when assessing the system for governing financial regulations. Indeed, there are risks that the centralization of financial, economic, and political power in the name of financial stability could curtail the economic freedoms of many by funneling a larger proportion of resources to the few with political connections. A public sentinel such as the FRC could help in the design, reform, and implementation of financial policies that more appropriately balance social aims, including the sometimes competing goals of stability and dynamism.

Second, the popular debate about the failure -- or success -- of free financial markets is frequently counterproductive. At the most basic level, we have never had totally free, unregulated financial markets with sound property rights enforcement and we never will. The sanitized world of economic theory suggests that financial markets work fine when there are no information or transactions costs and no government-induced distortions. While this view provides a useful analytical benchmark, it does not represent a viable option in the real world. In the real world, widespread informational asymmetries impinge on the perfect functioning of financial markets. In the real world, politicians and rival factions have always -- and will always -- meddle in the financial system to tilt the flow of society's savings toward preferred and not just public ends. In the real world, we are unlikely to create a financial system that is free from political interference and the distortions that those interventions sometimes create. Thus, the great challenge lies in creating a governance structure that increases the probability that financial regulations expand economic freedom and thereby boost social welfare. The FRC is a proposal for taking a step in this direction.

At a more complex level, the debate over regulation and free markets frequently takes a more pernicious turn. On the one side, some argue that fewer regulations are everywhere and always better than more regulations, and that allowing financiers to innovate around regulatory impediments is an effective form of deregulation that improves the functioning of the financial system. But, there is no theoretical foundation for this view: It is well-known that the removal of one regulation, when there are other market and policy distortions, could trigger socially destructive behavior by financial market participants. While perhaps an unfair caricature, this deregulation ideology is closely aligned with Alan Greenspan and the policy response by the Federal Reserve and other regulatory agencies that led up to the crisis. On the other side, the existence of market failures has led many to argue that official regulations will improve the operation of financial markets. This too is wrong in theory and destructive in practice. Simply because government interventions could in theory improve the operation of financial markets does not imply that regulations in practice will improve social welfare. Indeed, the enormity of evidence from across the globe and throughout history suggests that governments often act on behalf of small, powerful elites, not on behalf of the public.

Thus, we return to the complex, messy battles among competing factions that challenged Madison, where in these battles the public's interests are sometimes only weakly represented. We return not to a consideration of particular regulations, but to the desirability of rethinking the governance structure for selecting, interpreting, assessing, and implementing those regulations. Thus, after briefly explaining the importance of the financial system for economic welfare in Section 1, I provide examples of the failure of the regulatory system in Section 2. I do not focus on the problems with particular regulations, but rather on the failure of the system governing the implementation of financial regulations. Section 3 sketches the FRC and concludes.

Before continuing, I recognize that this paper is primarily a repackaging of the ideas and insights of many others. On the political economy of finance, research by Bodenhorn (2003), Hammond (1957), Haber (2009a, b), Kroszner and Strahan (1999), and White (1982) have shaped my views. On conflicts of interest and incentive problems within financial regulatory agencies, Kane's (2008, 2009a, b, c) work has exerted a defining influence. And, the details of the factors underlying the recent crisis have been assembled by many others, including the Barth et al (2009), Brunnermeier (2009), Caprio, Demirgüç-Kunt, and Kane (2008), and Cecchetti (2009). Furthermore, the idea for creating an auxiliary institution with the sole power to demand information and foster transparency seems to originate with the supervision of railroads in Massachusetts by Charles Adams, which is recounted in McCraw (1984). Rather than advancing novel ideas, the purpose of this paper is to highlight the importance of rethinking the governance of financial regulation.

1. Finance Matters beyond Crises

There are three critical empirical findings about the impact of the financial system on the economy. First, improvements in the operation of financial markets and institutions accelerate the rate of economic growth by increasing the efficiency of capital allocation. As reviewed by Levine (1997, 2005), the effectiveness with which the financial system mobilizes savings, allocates capital, monitors the use of that capital, and provides mechanisms for pooling and diversifying risk exert a first-order impact on long-run economic performance.

Second, improvements in finance exert a disproportionately positive impact on relatively low-income families, indicating that financial development expands economic opportunities.[1] As

[1] The literature considers three related, though clearly distinct and potentially contradictory, definitions of inequality. Many researchers stress equality of opportunity. Others emphasize the intergenerational persistence of

documented more extensively in Demirgüç-Kunt and Levine (2009), the operation of the financial system affects the degree to which a person's economic opportunities are bounded by individual skill and initiative, or whether familial wealth, social status, and political connections delineate the contours of one's economic horizons. The financial system influences who can launch a new business venture and who cannot, who can acquire education and who cannot, who can pursue one's economic dreams and who cannot. The operation of the financial system affects the degree to which capital flows to those with the best ideas and ingenuity or to those with the wealthiest and most politically powerful relatives and acquaintances. Finance fundamentally shapes the distribution of economic opportunities.

Third, financial innovation is crucial – perhaps indispensable – for sustained economic growth. As discussed in Baskin and Miranti (1997), Tufano (2003), Goetzmann and Rouwenhorst (2005), and Michalopoulos, Laeven, and Levine (2009), financial innovations have been essential for permitting improvements in economic activity for several millennia. Whether it was (i) the design of new debt contracts six thousand years ago that boosted trade, specialization, and hence innovation, (ii) the creation of investment banks, new accounting systems, and novel financial instruments in the 19th century to lower the barriers to ease the financing of railroads, (iii) or the development and modification of venture capital firms to fund the development of new information technologies and innovative biotechnology initiatives, financial innovation has been a critical component of fostering entrepreneurship, invention, and improvements in living standards.

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cross-dynasty relative income differences. Still others concentrate on income distribution because (1) they use income distribution to proxy for equality of opportunity or intergenerational persistence or because (2) income distribution is an independently worthwhile focus of inquiry, as relative income directly affects welfare. Since my goal is simply to note that a considerable body of research relates the operation of the financial system to various concepts of the distribution of economic opportunity, I do not distinguish among these different views of economic inequality, but see Demirguc-Kunt and Levine (2009).

While perhaps natural in the current climate, I believe it would be inappropriate to dismiss the historical evidence on financial innovation as either (i) an idealized view of financial innovation, or (ii) as a banal truism. The evidence does not imply that financial innovation is unambiguously positive. Financial innovations are frequently implemented simply to avoid regulations, and they played prominent roles in triggering our current suffering. At the same time, the evidence implies more than the trivial axiom that financial innovation is not always bad. Existing research suggests that financial innovation is an indispensable ingredient in fostering economic growth and expanding economic opportunities, and this should be incorporated into our rethinking of the governance of financial regulations.

These observations advertise two desirable characteristics of a system for governing financial regulations: (1) the financial regulatory regime should not focus exclusively on stability since financial development and innovation matter for the well-being of the population; and (2) the regulatory regime must adapt to financial innovation, or well-reasoned, well-structured regulations will become obsolete and potentially detrimental to economic prosperity. While these arguments imply that finance matters beyond crises, I am not suggesting that crises are unimportant. Yet, reducing the risk of systemic crises is not the only goal of financial regulation and therefore is not the only consideration in rethinking the governance of financial regulations.

2. Regulatory incentives and competence contributed to the crisis

This section provides two examples of how financial regulators and politicians contributed to the crisis. In particular, taking regulatory power and bureaucratic boundaries as given, there were basic errors in the prudent exercise of regulatory powers. A financial regulatory system more devoted to the public interest could have substantially reduced the probability of the crisis as well as its severity without material changes in the law. These observations motivate the desirability of creating an auxiliary institution to enhance the governance of financial regulations.

For brevity, I only focus on two examples: (1) the regulation of credit default swaps and bank regulatory capital and (2) the creation and operation of SEC-approved credit rating agencies. There are many more examples that would illustrate how financial regulators, with frequent help from their political overseers, did not act in the public interest, including housing financing policies associated with Fannie Mae, Freddie Mac, the Federal Housing Administration, and the Federal Reserve (Wallison and Calomiris, 2009), recent evidence from the Federal Deposit Insurance Company's Inspector General material loss reports and the Federal Reserve's Inspector general investigations that bank regulators were frequently fooled by the short-term profits of banks and avoided confronting banks with troubling risk profiles, the SEC's blundering in dealing with and examining Madoff, and many more. I do not argue that these two examples are the most important regulatory failures. Rather, I use them to motivate the need for a more substantive rethinking of the governance of financial regulation than has emerged from the behavior of the regulatory authorities.

2.1 Credit default swaps and bank capital

Credit default swaps were invented to provide banks with a mechanism to reduce their credit risk exposure and to free up regulatory capital for other investments. Gillian Tett (2008) entertainingly and insightfully describes the invention of credit default swaps (CDSs) by JP Morgan in 1997, and their explosive growth during the next decade. A CDS is essentially a bilateral insurance contract written on the performance of a security or bundle of securities. For example, purchaser A buys a CDS from issuer B on security C. If security C has a predefined "credit related event," such as missing an interest payment, receiving a credit downgrade, or filing for bankruptcy, then issuer B pays purchaser A. However, CDSs were carefully crafted so that they are not formally treated as insurance contracts, which would expose them to much greater regulation; rather, they were designed as financial derivatives so that they could be transacted in less regulated, over-the-counter markets. By 2007, the CDS market had a notional value of about $62 trillion according to Barth et al (2009).

Some of the largest banks relied heavily on CDSs to hedge themselves against losses on securities and to reduce regulatory capital. Regulators treated securities guaranteed by a seller of CDSs as having the risk level of the seller of the CDS. For example, a bank purchasing full CDS protection from American International Group (AIG) on collateralized debt obligations (CDOs) linked to sub-prime loans would have those CDOs treated as AAA securities for capital regulatory purposes because AIG had received an AAA rating from a Nationally Recognized Statistical Rating Organization, i.e., from a government-approved credit rating agency. Thus, banks purchased CDSs, so that they could free up capital reserves to invest in more lucrative assets.

Many entities purchased and sold CDS protection, including major U.S. and foreign commercial banks and AIG, the world's largest insurance company. For example, AIG had a notional exposure of about $500 billion to CDSs (and related derivatives) in 2007, while having a capital base of about $100 billion, which should have given rise to concerns about the ability of AIG to honor its commitments. Nonetheless, since the credit rating agencies judged AIG to be supremely safe, the banks purchasing CDSs on risky securities from AIG could free up capital to support riskier, higher-return assets. Across all sellers of CDSs, the largest U.S. commercial banks purchased $7.9 trillion in CDS protection, thereby reducing regulatory capital (Barth et al., 2009).

Much has also been written about the supposed inability of regulators to even monitor CDSs due to the Commodity Futures Modernization Act of 2000. Through 2008, virtually all CDS transactions were done over-the-counter, so there was no centralized clearing house or exchange to collect basic information about the CDS market. With the passage of the 2000 Modernization Act, the Securities and Exchange Commission (SEC) was granted authority over CDSs. The SEC argued that the Act impeded them from collecting information about the CDS market and requiring disclosures regarding the credit default positions of financial institutions. Yet, once the crisis hit, the NY Federal Reserve Bank called for market participants to submit a cleared facility solution for CDS contracts before the end of 2008. Four major contenders are competing to become leaders in clearing CDS.[2] The rapid response to the Federal Reserve's call for clearing houses and exchanges for CDSs occurred without the repeal of the Commodity

[2] These four are CME Clearing, a joint-venture between the Chicago Mercantile Exchange and hedge fund monolith Citadel; Liffe, NYSE-Euronext's futures and options subsidiary which has partnered with the London-based clearing provider LCH.Clearnet; Eurex, Deutsche Börse's derivatives exchange; and ICE US Trust, a start-up founded by Intercontinental Exchange (ICE), the US futures and commodities exchange, in conjunction with The Clearing Corporation, a dealer-owned consortium in which ICE recently bought a major stake.

Futures Modernization Act, suggesting that the constraints felt by the SEC in terms of collecting information on the CDS markets had more to do with the will to act, rather than its legal ability.

More importantly, bank regulators, such as the Federal Reserve, were not compelled to allow banks to avoid setting aside reserves to cover potential losses when banks purchased CDSs: This was a choice. For instance, see Interpretive Letter #988 of April 2004, which was jointly issued from the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency. It was no secret to the Federal Reserve and other regulators that several large banks were using CDSs to reduce regulatory capital and it was no secret that AIG was a large seller of CDSs to financial institutions around the world. The regulatory apparatus chose to allow this.

Regulators could have made a different choice based on the following assessment: (1) Federal Reserve does not have a sound method for assessing the true counterparty risk associated with those selling CDSs to banks; and, the Federal Reserve is unsure whether the credit rating agencies have the incentives and ability to assess the risk of financial institutions selling CDSs to banks; (2) The largest banks are heavily using these CDS to reduce capital requirements; (3) The Federal Reserve responsibility is to maintain the safety and soundness of banks, which relies on banks having capital commensurate with their risk; (4) Therefore, the Federal Reserve will prohibit banks from reducing regulatory capital by purchasing CDSs until it can accurately assess the counterparty risk of those selling CDSs to the banks. This very simple, prudent assessment would have materially changed one factor fueling the increase in bank risk taking. This choice would have hurt the short-run profits of banks, and banks would have ferociously lobbied against such a decision. Nevertheless, bank regulators had the discretionary power to limit the ability of banks to use credit derivatives to reduce their capital cushions.

The Federal Reserve and other bank regulators made the choice to allow banks to reduce capital through the use of CDSs even though they knew of the growing problems in the CDS market, the growing counterparty risk facing banks, and the lax mortgage standards underlying the deteriorating state of the U.S. financial system. For instance, Tett (2009, p. 157-163) recounts how Timothy Geithner, then President of the New York Federal Reserve Bank, became exceedingly concerned in 2004 about the lack of information on CDSs and the growing counterparty risk facing banks. Other insider accounts by, for example, Lewis (2009) and McDonald (2009), show that the Federal Reserve and financial market participants clearly knew that AIG was taking on massive risk by 2006. In an exhaustive study, Barth et al (2009, p. 184-193) demonstrate through the use of internal documents that the Federal Reserve was aware of the myriad of problems surrounding mortgage financing for many year before the bubble burst. Furthermore, although the demise and government conservatorship of AIG in the September of 2008 is sometimes discussed as a complete surprise, it was not a surprise to Time magazine, which ran an article on March 17, 2008 titled, "Credit Default Swaps: The Next Crisis." The article reported that AIG had recently taken an $11 billion write-down on its CDS holdings and that loses on CDS holdings severely damaged Swiss Reinsurance Co. and monoline bond insurance companies, including MBIA and AMBAC Financial Group Inc. The article noted explicitly that these developments could be devastating for the financial institutions that purchased credit protection from these insurers.[3] This raises serious questions: Why did regulators not respond to these signals and why did regulators not prepare for the potential failure of AIG or other major sellers of CDSs? So far, U.S. taxpayers have handed over $160 billion to AIG.

[3] Yet, on March 16, 2008 on CNN, Treasury Secretary Paulson noted that, "I have great, great confidence in our capital markets and in our financial institutions. Our financial institutions, banks and investment banks, are strong." This quotation is taken from Barth et al (2009, p. 1).

Yet, the Federal Reserve's Chairman had few reservations about the use of credit derivatives. In several speeches, Alan Greenspan (2005) argued that credit default swaps "… have enabled the largest and most sophisticated banks in their credit-granting role to divest themselves of much credit risk by passing it to institutions with far less leverage." This was a choice, not a regulatory gap, nor a lack of supervisory power, nor a glitch in the rules. As argued by Barth et al (2009, p. 184):

> *… even if the top officials from these regulatory agencies did not appreciate or wish to act earlier on the information they had, their subordinates apparently fully understood and appreciated the growing magnitude of the problem.*

2.2 Nationally Recognized Statistical Rating Organization

These errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue, or a little bit of both.

A Moody's managing director responding anonymously to an internal management survey, September 2007.[4]

The major incentive problems that plague credit rating agencies have been well-understood for over two decades and carefully documented by a range of scholars, including Partnoy (1999). Yet, over these decades, credit rating agencies grew to play an increasingly pivotal role in the global financial system, spurred by the support, if not blessing, of financial regulators. This official support included both the active sponsorship of credit rating agencies by the SEC and the passive acquiescence by financial regulators as the quality of ratings deteriorated and rating agency incentives become dangerously distorted.

Until the 1970s, credit rating agencies were comparatively insignificant, moribund institutions that sold their assessments of credit risk to subscribers. Investors paid credit rating

[4] Quoted from "Debt Watchdogs: Tamed or Caught Napping?" by Gretchen Morgenson, New York Times, December 7, 2008.

agencies to evaluate the quality of securities. Given the poor predictive performance of these agencies during the 1920s, the demand for their services was very limited for much of the 20th century (Partnoy, 1999). Indeed, academic researchers found that credit rating agencies produced little additional, valuable information about the firms they rated and their ratings tended to lag stock price movements by about 18 months (Pinches and Singleton, 1978).

In the 1970s, credit rating agencies experienced two huge interrelated changes. First, the SEC created the Nationally Recognized Statistical Rating Organization (NRSRO) designation, which the SEC granted to the largest credit rating agencies. The SEC then relied on these SEC-approved agencies to calculate the credit risk of numerous entities, including the broker-dealers regulated by the SEC. The SEC then set capital regulations based on the risk assessments of the NRSROs.

The creation of and reliance on NRSROs triggered a cascade of regulatory decisions that dramatically increased the demand for the services provided by these SEC-approved agencies. The SEC, bank regulators, insurance regulators, other Federal agencies, states, municipalities, regulatory agencies in other countries, foundations, and numerous private entities all started using NRSRO ratings to establish investing rules and set capital regulations on virtually all financial institutions. For example, the SEC and bank regulators used the ratings of NRSROs to evaluate the risk of financial institutions and establish their capital requirements. Federal agencies used the risk designations of the NRSROs to define the types of securities various organizations, including government sponsored entities (GSEs) like Fannie Mae and Freddie Mac, could purchase and how much capital needed to be held in reserve against particular assets. The investment opportunities, capital requirements, and hence the profits of insurance

companies, mutual funds, pension funds and a dizzying array of other participants in financial markets were materially shaped by how NRSROs rated securities.

Indeed, Partnoy (1999) argues that NRSROs sell regulatory licenses. If an issuer wants the major financial institutions -- commercial banks, broker-dealers, insurance companies, pension funds, etc. -- to have the regulatory latitude to purchase its securities, the issuer must obtain a particular rating from the NRSRO. As long as the financial regulatory authorities defined asset allocation restrictions and regulatory capital using NRSRO ratings, there was an enormous demand for NRSRO services. This demand was not always sensitive to the actual quality of the rating agencies.

Second, in the 1970s, credit rating agencies started selling their ratings to the issuers of securities despite the clear conflicts of interest. Issuers also have an interest in paying rating agencies more for higher ratings since those ratings influence the price that issuers can obtain for the security. Interestingly, the vice president of Moody's explained in 1957 that, "[W]e obviously cannot ask payment for rating a bond. To do so would attach a price to the process, and we could not escape the charge, which would undoubtedly come, that our ratings are for sale."[5]

While recognizing the conflicts of interest, credit rating agencies have argued that reputational capital reduces the pernicious effects of these conflicts. If a rating agency does not provide sound, objective assessments, it will lose reputation and investors will no longer use ratings from that agency in making asset allocation decisions. This will reduce demand for all securities rated by that agency, so that all issuers using that rating agency will face lower prices for their securities. From this perspective, reputational capital is vital for the long-run

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[5] Quoted from "Debt Watchdogs: Tamed or Caught Napping?" by Gretchen Morgenson, New York Times, December 7, 2008.

profitability of credit rating agencies and will therefore contain any short-run conflicts of interest associated with "selling" a superior rating on any particular security.

From this perspective, reputational capital will reduce the short-run temptations created by conflicts of interest if the following two, related conditions hold: (1) decision makers at rating agencies have a long-run profit horizon, and (2) demand for securities responds appropriately to poor rating agency performance, so that decision makers at rating agencies are punished if they "sell" bloated ratings on even a few securities.

These conditions did not hold, however, suggesting that reputational concerns provided exceedingly weak constraints on the conflicts of interest distorting rating agency behavior. First, especially with the explosion in the rating of structured products and the ability of rating agencies to sell ancillary consulting services, rating agencies could book massive profits in the short-run and worry about reputation losses later, if at all. Besides purchasing ratings, issuers of securities would also pay the rating agency for pre-rating evaluations, corporate consultations, and guidance on how to package securities. Thus, financial innovations -- the boom in the issuance of structured products and the increased provision of consulting services by the NRSROs to issuers -- intensified the conflicts of interest facing rating agencies, but the regulatory community did not adapt. Distressingly, the intensification of conflicts of interest through the selling of consulting services by rating agencies closely resembles the amplification of conflicts of interest when accounting firms increased their sales of consulting services to the firms they were auditing. This facilitated the corporate scandals that emerged less than a decade ago, motivating the Sarbanes-Oxley Act of 2002. Yet, still, regulators did not respond as rating agencies pursued these increasingly profitable lines of business.

Moreover, official regulations actually weakened the degree to which reputational concerns would constraint rating agencies; that is, regulators effectively weakened the feedback from poor rating performance to a drop in NRSRO revenues. Many purchasers of securities were forced -- by regulation -- to purchase only securities rated at a particular level by an NRSRO. This regulatory requirement held regardless of NRSRO performance, moderating the degree to which poor ratings performance reduced demand for NRSRO ratings and hence reducing the impact of ratings quality on an agency's bottom-line. The feedback from rating agency performance to their bottom-line has been further weakened by the inability of purchasers of ratings to sue rating agencies in general and the executives of these agencies in particular. Rating agencies claim that their ratings are simply opinions, which are protected by the Fifth Amendment right of free speech. The agencies and executives claim that they bear no responsibility of the quality of those ratings. Thus, rating agencies face little market discipline, no regulatory oversight, and yet virtually all major issuers of securities in world must purchase their ratings and virtually all major purchasers of securities in the world face regulatory constraints on what they can purchase based on these ratings. It is good to be an NRSRO.

Given the regulatory-induced incentives and protections enjoyed by NRSROs, their behavior and profitability are unsurprising. Lowenstein's (2008) excellent description of the rating of a mortgage backed security by Moody's demonstrates the speed with which complex products had to be rated, the poor assumptions on which these ratings were based, and the profits generated by rating structured products. Other information indicates that if the rating agencies issued a lower rating than Countrywide (a major purchaser of NRSRO ratings) wanted, a few phone calls would get this changed.[6] The profits margins enjoyed by NRSROs were

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[6] See the report by Gretchen Morgenson, "Debt Watchdogs: Tamed or Caught Napping?" in the *New York Times* on December 7, 2008.

extraordinary. For example, the operating margin at Moody's between 2000 and 2007 averaged 53 percent. This compares to operating margins of 36 and 30 percent at the exceptionally profitable Microsoft and Google, or 17 percent at Exxon. It is true that the performance of the rating agencies played a central role in the crisis. But, it is also true that the financial regulators established the privileged position of rating agencies and protected them from the discipline of the market.

3. Conclusions and a Proposal: The Financial Regulatory Commission

3.1 Preamble

The examples presented above are simply meant to illustrate that there are serious problems in the governance of financial regulations and that repairing regulatory gaps and reassigning powers among agencies are unlikely to rectify all of these problems. As we all too sadly know, failures in the governance of financial regulation and supervision have enormous ramifications for the welfare and economic opportunities of individuals. This should motivate policymakers and policy analysts to look beyond particular rules and agency mission statements and to reevaluate the system for selecting, evaluating, reforming, and implementing financial regulations. At the same time, serious proposals for improving the governance of financial regulation should fit easily within the historical and institutional context of the country.

In light of these conclusions, I sketch a proposal for a Financial Regulatory Commission (FRC). One might accept the desirability of reevaluating the governance of financial regulation and yet reject the FRC proposal. I simply offer the FRC as one potential strategy for improving the design, implementation, and evolution of financial regulatory and supervisory techniques, while recognizing that the FRC is not without its own shortcomings.

To be clear, I am addressing the problem of regulatory governance and avoiding other key questions, such as (i) which are the right regulations for achieving desirable outcomes, such as stability, growth, and innovation, (ii) what are the right trade-offs among these potentially competing outcomes, and (iii) how should uncertainty concerning the actual effects of particular regulations influence policy decisions? I address some of these questions in Barth, Caprio, and Levine (2006). Rather, this paper proposes a mechanism for improving regulatory governance: the system for selecting, interpreting, and implementing regulations. As suggested in the Introduction, there is frequently an enormous divergence between actual regulatory policies and those that the public would choose if it had more accurate information about and control over the behavior of elected officials and regulators. The goal of the FRC is to induce the governance structure to enact and implement financial policies more aligned with this public interest.

3.2 The Sentinel

The purpose of the FRC is to increase the probability that the country establishes regulatory and supervisory practices that operate in the best interests of the public. As argued above, various incentive problems sometimes hinder the realization of this goal through the existing governance structure.

The only power of the FRC would be to acquire any information that it deems necessary for evaluating the state of financial regulation over time, including the rules associated with the corporate governance of financial institutions. Any information collected by the FRC would be made publicly available, potentially with some delay. Transparency is necessary; thus, the law establishing the FRC must clearly and unambiguously assert that the FRC should be granted immediate and unencumbered access to any information it deems appropriate from any and all

regulatory authorities and financial institutions. FRC demands for information should trump the desires of regulatory agencies for discretion, secrecy, and confidentiality. Besides allowing the FRC to assess the state of financial regulation, transparency will enhance market oversight of financial institutions and regulatory bodies.[7] While many have expressed concerns that transparency will destabilize markets, there is more evidence that concealing information in the name of confidentiality hinders the efficiency of financial intermediation, the effectiveness of financial regulation, and the stability of financial systems. Experience suggests erring on the side of transparency. This "sunshine" regulatory approach has a long and promising history in the United States as discussed in McCraw's (1984) impressive book. This approach is also fully consistent with the checks and balances deeply ingrained in the fabric of U.S. political institutions. In other words, the basic purpose and power of the FRC are quite conventional, not radical.

The only responsibility of the FRC would be to deliver an annual report to Congress and the President assessing the current and long-run impact of financial regulatory and supervisory rules and practices on the public. By having no official power over either the regulatory agencies or financial markets and institutions, the FRC would be less constrained in its assessments than an entity with operational responsibilities. While regulators might avoid taking various actions against financial institutions it regulates since that might imply a failure of regulation, the FRC would face fewer hindrances. While one regulator might avoid criticizing another regulator's actions to avoid cross-regulatory conflicts, the FRC would be less reticent. While existing

[7] Transparency is necessary, though insufficient, for improving the governance of financial regulation. As Macey (2003, p. 332) notes, "In the disclosure context, this means that in order for an economy to have an adequate system of financial reporting, it is not enough that companies make disclosures of financial information. In addition, it is vital that there be set of financial intermediaries, who are at least as competent and sophisticated at receiving, processing, and interpreting financial information (and other information about company performance) as the companies are at delivering it." I would add that incentives are vital too. It is not enough to have informed, competent intermediaries and regulators. It is essential that these entities have the incentives to acquire, process, and use the information to improve the operation of financial markets.

regulatory agencies have internal auditing departments, the FRC would play a different role. These auditing departments perform an important role in assuring that the particular regulatory agencies adhere to their particular rules. Instead the FRC would have much broader responsibilities for assessing the impact of the overall constellation of regulatory and supervisory practices on the financial system. No other independent entity has this role, and the absence of such an institution was clearly evident in the design, implementation, and evolution of financial policies during the last decade.

The major design challenge is to create an FRC in which the professional ambitions and personal goals of its staff align with its mission of boosting the degree to which financial regulations reflect the public interest. As argued by James Madison, the goal is set ambition against ambition, so that the private interests of those working in the FRC align with its mission.

Here are a few suggestions toward this end. The most senior members of the FRC would be appointed by the President and confirmed by the Senate for staggered and appropriate long terms. As with the Board of Governors of the Federal Reserve System, the goal is to limit the short-term influence of politics on the evaluations of the FRC. The senior members of the FRC would also be prohibited from receiving compensation from the financial services industry, even after completing their tenure at the FRC. Since exactly those individuals with sufficient expertise to achieve the goals of the FRC would also have lucrative opportunities in the private sector, this could involve such an enormous personal sacrifice that it would severely limit the pool of qualified people available to the FRC. Thus, staffing the FRC with talented, well-motivated individuals will require a different compensation schedule than currently contemplated in public sector jobs. While problematic, a more lucrative compensation plan is necessary for limiting conflicts of interest while attracting excellent people to the FRC. At the same time, the FRC

would be a prominent entity. Those working for the FRC could advance a wide-array of professional ambitions and attain considerable prestige and influence after leaving the FRC by accurately assessing financial regulations. The opportunity to improve financial sector policies and achieve these career aspirations would work to attract talented individuals to the FRC.

3.3 Impact and desirability of the Sentinel

The FRC would enhance the governance of financial regulation in a number of ways. First, it would increase transparency. Thus, it would increase the number of individuals and entities capable of monitoring the design, implementation, and effects of financial regulations. Second, the FRC represents another set of experts evaluating, analyzing, and assessing the complex interactions among regulatory agencies and the quickly innovating financial sector. This would increase the chances for identifying and fixing distorted incentives and ineffective policies quickly. Third, knowing that the FRC is going to scrutinize its actions would increase the performance of regulatory agencies. Thus, the mere existence of the FRC might have reduced the dubious actions and inactions of the SEC and Federal Reserve noted above during the most recent crisis. Fourth, and perhaps most importantly, the FRC would continuously reassess how regulatory and supervisory practices affect the incentives faced by the financial system. Since financial systems are dynamic, it is vital to relentlessly reevaluate the incentives shaping the behavior of financial market participants. As the latest crisis suggests, a regulatory system that worked well before structured financial products emerged did not work as well afterwards. By constantly assessing the impact of financial policies, the FRC would reduce the likelihood that financial policies become obsolete or dangerously distort the decisions of financial institutions.

A natural complaint about the FRC proposal is perhaps best expressed as an exasperated question: Do we really need another institution to add to the alphabet soup of existing financial regulatory agencies?

My answer is "probably yes" for three reasons. First, recall that (1) private financial institutions play a role in selecting the presidents of the Federal Reserve Banks, (2) executives and staff members at the Federal Reserve, SEC, and other regulatory officials can, and very frequently do, move from their public jobs into much more lucrative jobs in the private section, and (3) the Federal Reserve, SEC, and other regulators have direct regulatory influence over financial institutions, which could adversely affect the objectivity with which they assess their own performance. Second, the internal inspector general department of each particular regulatory authority is not charged with examining how the full array of financial regulations across many regulatory authorities coalesces to affect the incentives of financial institutions and markets. Therefore, they cannot, play the role of a "Sentinel" over financial sector policies in general. Third, the General Accounting Office does not currently play the role of the Financial Regulatory Commission, though the FRC could fit comfortably within the purview of the GAO. In particular, the FRC needs (i) the power to demand whatever information is necessary from private entities and regulatory bodies to assess the state of financial regulation, (ii) a very diverse staff with expertise in banking, securities markets, corporate finance, regulation, and the law that have an ongoing commitment to evaluating financial regulations in general and that have the professional skills and stature to confront powerful private institutions, regulatory bodies, and Congress itself, and (iii) the explicit mandate of providing a forward looking assessment of how the full array of financial policies affect the economy.

As a sentinel over financial regulatory and supervisory practices, the FRC would act as an auxiliary precaution for improving the performance of government and official agencies in the design, implementation, and reform of policies affecting the financial sector. Although not impervious to mistakes and corruption itself, these problems would not align perfectly with those plaguing existing regulators, increasing the chances that the FRC would push financial regulation in a more socially optimal direction. Though incomplete, the FRC represents a proposal for increasing the probability that the design and execution of financial regulations reflect the public interest that is fully consistent with the cultural and institutional norms of the country.

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