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Regulatory Underkill

"Securities markets need more oversight, not less"

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By Arthur Levitt, Jr.

A little more than a year ago, some of the most eminent voices in the business community and leading policy makers — including the senior senator from New York, New York City's mayor, the head of the New York Stock Exchange, the leadership of the U.S. Chamber of Commerce and the Secretary of the Treasury — warned that Wall Street's predominance in the world economy was in danger of being eclipsed.

Their concern was not with diminishing transparency, lax accounting standards, or the growing inability to measure the risk of new financial instruments and opaque trading mechanisms. No, their concern was regulatory overkill — that the NYSE was losing listings to overseas markets. How ironic that this group was fixated on a questionable measure of market health, while the seeds of today's market turmoil were being nourished not by regulatory excess, but by fundamental failures in oversight at almost every level.

With this week's downfall of Bear Stearns, and the worsening of the credit crunch, it is clear that there was a breakdown in how Main Street and Wall Street interacted with each other and the global capital markets. Wall Street's new financial products created incentives for Main Street mortgage lenders to offer loans to previously unqualified borrowers.

With easy credit, millions of people bought homes, propping up the market for securities built from these mortgages. Meanwhile, key standard-setters were asleep at the wheel; federal regulators turned from impartial referees to industry enablers; and important gatekeepers became knotted in conflicts of interest. As a result of these regulatory failures, investors have been left with opacity instead of transparency, fueling their mistrust and the current panic roiling the markets.

How did this happen?

First of all, the combination of structured financial products and subprime mortgages fundamentally changed the lending business. No longer did those doing the lending have to expose themselves to the credit risks of the borrowers. Instead, they packaged their loans for sale to the investing public. With no exposure, loan originators offered mortgages to just about anyone they could find. Unlike the state regulators who sounded alarms, almost all federal banking regulators (except Ned Gramlich, the late Fed governor) stood by cheering securitization as underwriting standards deteriorated.

Accordingly, state and federal banking regulators, under the oversight of Congress, need to act now — together — to create enhanced underwriting standards for loans, ensuring that lending practices are commensurate with the risks, and that the lender and borrower are fully informed of these risks.

We must strengthen the licensing standards and oversight of mortgage brokers and originators, as proposed by the President's Working Group on Financial Markets. And we must increase the capital requirements for monoline insurers, as well as greatly enhancing their disclosures of actual and potential ranges of losses from different product lines.

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The second factor behind today's market turmoil was the strong ratings bestowed upon the new securitized debt instruments by credit rating agencies. What investors relying upon these ratings didn't know was that the agencies' objectivity was severely compromised — as they were helping issuers construct the very financial instruments they eventually judged. Meanwhile, the Securities and Exchange Commission (SEC) lacked sufficient power and resources to inspect and take corrective supervisory or enforcement actions. As a result, this conflict of interest persisted.

Credit rating agencies need to adopt, as they have proposed, systems that more accurately reflect the risks of differing types of debt. But Congress should give the SEC greater authority to examine the reasonableness of the ratings issued, to take enforcement actions if necessary, and to be able to set independence standards for the rating agencies as the SEC now does for auditors.

The third factor responsible for today's troubles is that, once structured financial products were purchased, investors had little ability to discover how exposed banks were to these products' risks. Failing to recognize and understand the changing risks and accompanying lack of transparency for investors, the Financial Accounting Standards Board (FASB), and the SEC that oversees it, allowed Structured Investment Vehicles (SIV) and conduits to be kept off bank balance sheets.

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Because this loophole was not closed when it was first recognized more than five years ago, we are today still trying to figure out the depth and severity of the current crisis. If the FASB is to maintain its credibility with investors, it will need to bring the off-balance sheet risks and losses associated with both SIV's and other securitizations onto companies' financial statements, with full disclosure, within the next 12 months.

Finally, the management and boards of directors of these financial services firms, such as Bear Stearns and probably others, failed to put in place adequate risk-management systems. Moreover, the Fed, SEC, and the Office of the Comptroller of the Currency did not take any meaningful, proactive regulatory action to require needed improvements in risk management and public disclosure, ignoring the recommendations of their own Working Group on Public Disclosure made seven years ago.

At the very least, the board of every public company should adopt best practices in risk management and disclose those practices to investors, along with significant accompanying risks, and how they are managed.

Beyond these immediate fixes, what's needed to restore public confidence is a more wholesale reconsideration of how we can inject greater transparency into the markets and bring about a change in attitude on the part of business leaders and policy makers that puts the interests of investors first. This may require a more fundamental restructuring of how we regulate the markets — for instance, merging the SEC and the Commodities Futures Trading Commission to create a single securities regulator — and giving that regulator the resources and the authority to do its job, something the SEC currently lacks.

Ultimately, those who were so concerned with Wall Street's competitiveness need to realize that the true competitive advantage of America's capital markets has long been their high quality. With that quality in doubt, leaders and policy makers need to put their ideological fixations aside and commit themselves to giving investors the levels of transparency and accountability they deserve and expect from the world's strongest markets.

Only then will trust be restored, our markets' health revived, and a deep economic crisis averted.

Mr. Levitt was chairman of the SEC from 1993 to 2001.

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