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THE BEST POLICY

The Regulatory Charade

Washington had the power to regulate misbehaving banks. It just refused to use it.

By Eliot Spitzer

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Does it strike you as odd that the American government has invested $115 billion in TARP money alone in Citibank, JPMorgan Chase, and Bank of America, fully 70 percent of their market cap ($164.5 billion, as of March 30), yet we have virtually no say in the management or behavior of these banks? Does it seem even odder that these banks are getting along extremely well with the government regulators who should be picking them apart for having destroyed the economy and financial system?

There is a grand, implicit bargain being struck in our multitrillion-dollar bailout of the financial-services sector. Those in power in D.C. and New York are pretending the bargain is: You give us trillions, and in return, we fix this industry so the economy recovers and this never happens again. In fact, the bargain is much more alarming: Trillions of dollars of taxpayer money will be invested to rescue the banks, without the new owners—taxpayers—being allowed to make any of the necessary changes in structure, senior management, or corporate behavior. In return, the still-private banks will help the D.C. regulators perpetuate the myth that regulators didn't have enough power to prevent the meltdown. In sum, banks get bailed out with virtually no obligations imposed; regulators get more power and a pass on their past failures. The symbiosis of the past decade continues.

We already see regulators, supported by investment and commercial banks, calling for expanded power—specifically the ability to reach hedge funds and other "private equity" with more oversight and to seize institutions that pose systemic risk with greater alacrity.

Each is a worthy regulatory idea. But each is essentially irrelevant to the problems that got us where we are. The new line from Washington and Wall Street is that hamstrung regulators lacked the power to stop malfeasance before the crisis. This is wrong. Washington had enormous power over the misbehaving investment banks, commercial banks, and ratings agencies. It just refused to use that power.

Financial-services companies have been given multiple blank checks, worth hundreds of billions, yet there have been virtually no mandated changes in management, behavior, or lending practices. Nor have bondholders in that sector been required to take a haircut, as they have been elsewhere. GM was required to replace its CEO, Rick Wagoner, and auto company stockholders, bondholders, and unions have all been required to take substantial haircuts.

In return for the free money, the financial-service companies only have to play along with the face-saving myth: The regulators at the Fed, the FDIC, the OCC, Treasury, OTS, etc. would have done better if only they had had more power over "rogue" free-floating funds of capital—hedge funds and private-equity funds. Hence the call for broader authority.

Now, adding coherence and structure to the crazy quilt of regulators we now have is fine, and something many have sought for a long time. But it is also unrelated to our current predicament.

The bad actors who got us where we are—ratings agencies, commercial banks, and investment banks that participated in the origination and securitization of the bad debt—have been squarely in Washington's regulatory sweet spot. The regulators had all the power they needed to peer deep inside the AIG counterparties to see if there was risk that should have been avoided. And, truth be told, they had that power with AIG as well. Today there is a hue and cry about hedge funds, but it is not hedge funds or private equity funds that are seeking bailouts and taxpayer subsidies.

So the question should be: Where were the regulators, and not only during the Bush administration, but also during the Clinton years? The answer is that they were either blind or willfully avoiding exercising the power they already had. The story is now well told that, from Alan Greenspan and Timothy Geithner at the Fed to Robert Rubin and Larry Summers at Treasury, to Harvey Pitt and Chris Cox at the SEC, regulators avoided the critical issues that were percolating in the financial community. They had the authority to set capital ratios and leverage limits and rap the knuckles of the clearly conflicted rating agencies. But they didn't.

Most of these are genuinely good people, and everybody who has been in a regulatory position has made errors. The issue is not placing blame. But it is understanding the genesis of the problem and ensuring that we find the right policy response. These fully empowered regulators fell into bubble-inducing behavior. They were susceptible to the same groupthink that accepted a faulty premise or theory of the moment, or they simply placed too much faith in the magic of the market. Bubbles and market irrationality happen—even with empowered regulators. Of course, aggressive regulators could have ensured that the bubble didn't last as long or get as dangerous as the last one did.

If regulators already had enough power, the simplistic belief that a smart new law will stop the problem next time is clearly false. Giving the regulators all the powers they now seek would not have changed their behavior. We would still be precisely where we are. We shouldn't forget that Sarbanes-Oxley was supposed to cleanse the markets. More laws will not do it.

Instead of creating new regulations and laws that don't really address the root causes of the crisis, we should look to a simpler but more fundamental way to limit systemic financial risk and simultaneously create a healthier financial marketplace: If it is too big to fail, break it up. We should not let any private institution become so big and central to the financial system that taxpayers become its guarantor. The problem is that this model doesn't fit into the secret grand bargain. On the contrary, the entire premise of the grand bargain is that the companies that were already too big to fail have been allowed to get even bigger. Socializing risk while privatizing gain—which is what having more and bigger "too big to fail" institutions guarantees for the future—doesn't work in the long run. Too big to fail, quite simply, is too big.

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