

Public Statement by SEC Chairman: A Brave New World For Financial Regulation

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The Fed's opening of new lending facilities to large investment banks this spring, after financing the sale of Bear Stearns, has helped restore confidence to financial markets. It has also posed some difficult questions.

How can a government-provided liquidity backstop be made consistent with strong market incentives for risk management? And what system of regulation for investment banks makes the most sense? These questions are especially challenging because the model of commercial bank regulation is difficult to apply to investment banks.

When Bear Stearns was acquired by J.P. Morgan, Bear's overall capital ratio comfortably met the Federal Reserve's 10% "well-capitalized" standard for commercial bank holding companies. Yet this didn't prevent a run on the bank. One reason is that capital and liquidity standards aren't the only things preventing bank runs. There is also deposit insurance, as well as the central bank's guarantee that it will make short-term liquidity available in a serious crisis. Lacking comparable protections, Bear Stearns found even its \$18 billion liquidity cushion inadequate in a crisis of confidence.

But preventing a run was not among the reasons Congress long ago gave the SEC the power to regulate the capital of an investment bank's broker-dealer. Investment banks, according to the conventional wisdom, were not subject to a run because they do not take deposits. Instead, SEC regulation was supposed to protect the broker-dealer's customers, which it did. The commission's customer protection rules, including segregated customer accounts, ensured that despite Bear's near-bankruptcy, at no time were its customers' cash and securities threatened.

It is clear that these protections are no longer enough. The Bear experience demonstrates that an investment bank can suffer a crisis of confidence that leads its customers and counterparties to precipitously withdraw funds — and threaten the

financial system. This threat is what led the Fed to use its authority to act as “lender of last resort” in the Bear crisis.

This entailed some significant improvisation, because Congress has made no explicit provision for treating investment banks like commercial banks for purposes of access to the Fed’s lending facilities. Instead, the Fed was required to find that Bear’s imminent bankruptcy constituted an emergency threatening a severe, adverse impact on the economy. But making Fed lending available to all investment banks has exposed a lack of symmetry with respect to the explicit statutory terms on which commercial banks get this privilege.

Unlike investment banks, commercial banks pay into an insurance fund. There are intentionally onerous statutory restrictions on banking regulators’ ability to give them lender-of-last-resort treatment. And in the event a commercial bank must be rescued, a special assessment on the entire industry is mandated to pay the costs.

Finally, the investment banks’ access to the Fed’s Primary Dealer Credit Facility and Term Securities Lending Facility comes without their being subject to the significant restrictions on business activities to which commercial banks are subjected.

Commercial bank holding companies are prohibited from entering into innovative lines of business without prior approval, and from most direct investments in real estate, commodities and other commercial activities.

These aspects of commercial bank regulation did not restrain their creation of the lower-quality mortgages and mortgage securities that led to the subprime crisis, or their sponsorship and support of the off-balance-sheet vehicles for securitized mortgages that deepened the crisis. Even so, such relatively intrusive regulation has long been thought necessary to mitigate the moral hazard problem that was created by the provision of central bank backstop liquidity, and other elements of the banking safety net such as deposit insurance.

Now the provision of backstop liquidity to the major investment banks has unavoidably reduced the penalties they face for taking on excessive risk. Thus the questions are squarely put: Should the extensive system of commercial banking supervision and regulation, developed in large measure to counter the problem of moral hazard, be extended to investment banks? If so, who should be responsible for it?

In the long run, it will be up to Congress to make the fundamental policy choice of whether taxpayer-funded liquidity facilities should be made available to investment banks on a permanent basis. Meanwhile, the situation in the wake of Bear Stearns has already necessitated major changes in the way investment banking supervision is conducted.

The SEC — which in 2004 patterned its voluntary program of investment banking supervision on the commercial bank regulators' use of the internationally agreed Basel II standards — has strengthened the liquidity requirements. With the Federal Reserve, we have developed additional stress scenarios for assessing liquidity. We have encouraged firms to strengthen their balance sheets, including by raising new capital where appropriate. And public disclosure of investment banks' capital, as well enhanced disclosure of their liquidity, will begin with their second quarter SEC filings.

In my judgment, explicit legislative authorization for what is now a purely voluntary program of SEC supervision is vital. But even if legislation is not forthcoming, the arrangements being worked out by the SEC and the Fed can serve as a sturdy approach for the indefinite future.

The success of this approach is dependent on a high level of coordination between the SEC and the Fed, to ensure consistent guidance. From the standpoint of the investment banks, the U.S. government must speak with one voice. Our experience thus far proves this is possible.

At the same time, maintaining the diverse perspectives of the Fed and the SEC, within a consultative process, is exceptionally useful. For financial institutions whose lifeblood is trading, not lending, there is as yet no agreed-upon "apples to apples" comparison of balance sheets and leverage metrics. Regulators must determine whether the different kinds of risks both types of institutions bear within the context of their business models are appropriate for our financial system as a whole.

Properly functioning investment banks are a critical engine of growth and innovation. We must be careful to construct a regulatory approach that meets our regulatory objectives without discouraging risk-taking or neutering Wall Street's ability to fuel economic growth and innovation. Not only the scope and character of investment bank supervision — but also the wisdom of an indefinite provision of backstop liquidity (with the additional regulation to mitigate moral hazard that this entails) — must be judged with this in mind.

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