The Current State of Financial Reform

March 26, 2010

Michael Konczal, The Roosevelt Institute

Executive Summary

The Senate bill is lacking in many of the essential areas for reform. Here are specific, targeted ways of strengthening the Senate bill:

- Hard limits related to both size caps relative to GDP and leverage ratio must be specified in the bill. This will put a floor to the difficulty of resolution and the damage to the economy.
- The Volcker Rule should be accepted outright, rather than through the decision of the Financial Stability Oversight Council.
- The Bureau of Consumer Financial Protection must have full rule-making authority over non-bank lenders, including auto lenders.
- The Bureau of Consumer Financial Protection must keep its lack of preemption over state regulation.
- The derivatives section should be included to require all standardized derivatives to trade on an exchange with clearing, keeping with the original financial regulatory reform language introduced by President Obama in June of 2009.
- The Financial Stability Oversight Council should not have the ability to alter the derivatives rules, override the Bureau of Consumer Financial Protection or change other regulations by a vote.
- Early remediation requirements should be defined as to intervene earlier than the event of financial decline for a large systemically risky financial firm with a rule written by Congress.
- There should be more focus on investing in high end, internationally focused position monitoring for large systemically risky financial firms.
- In the light of recent scandals, there should be extra language included that targets fraud in accountancy and directly addresses issues of off-balance sheet reform.

Talking Points

- There is too much discretion in the Senate Financial Reform Bill. Some hard numbers, like absolute leverage requirements or size caps relative to GDP, should be written into the legislation like in the House Bill. We shouldn't expect regulators to be perfect, but mostly to carry out simple rules.
- The Financial Stability Oversight Council this bill creates has too much discretion to overrule the bill after it goes into effect, by either waving requirements for derivative contracts, vetoing consumer protection laws, or refusing to abide by the Volcker Rule. If it is run by people who care more about the profits of big banks than the stability of our real economy, it could override a lot of our fragile regulation.
- Remember that derivatives reform is an essential part of resolution authority reform, and that without the former the latter is significantly weaker.
- Sunlight is the best disinfectant. Keeping derivatives on exchanges, allowing consumers to be well informed of the contracts they face and regulators aware of when and how they can wind down a large financial firm will help our real economy grow into the 21st Century after this financial sector trauma.

Michael Konczal, a Fellow with the Roosevelt Institute, works on financial reform, structural unemployment, consumer access to financial services, and inequality. He blogs for New Deal 2.0 and the Rortybomb, and his work has appeared at The Atlantic Monthly's Business Channel, NPR's Planet Money, the Baseline Scenario, Huffington Post, and The Nation. He was formerly a financial engineer and mathematical analyst. Konczal holds a MS in Finance and a BS in Mathematics from the University of Illinois at Urbana-Champaign.

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1.0 Introduction

Following the financial meltdown that occurred in Fall 2008, President Obama and his administration have made financial reform a crucial part of their legislative efforts.

In June 2009, the Obama administration released its financial reform white paper outlining the objectives it wanted to achieve in reforming the financial market.[1] On December 11th, 2009, the House passed H.R. 4173, The Wall Street Reform and Consumer Protection Act of 2009. And on March 15th, 2010, Chris Dodd released his version of the financial reform legislation.

How should one judge the success of each of these bills in bringing about healthy, functioning financial markets? I propose that there are four specific areas where we need new regulation. In each of these areas, there are two axes we can use to judge good regulation from the bad. In this paper I will discuss the axes for each of the four areas, and plot each of the three pieces of legislation on a graph in order to demonstrate their distance from functioning financial markets.

2.0 Consumer Financial Protection

Creating a Consumer Financial Protection Agency (CFPA), a unified federal consumer protection supervisor, has been one of the goals of the current financial regulatory effort.[2] On what bases should we judge how successful new regulatory efforts to protect consumers from abusive lending will be?

2.1 Independence

The first principle of a successful consumer financial protection agency is that it should be independent. It should have sole rule-making authority for consumer financial protection statutes. The current regulatory system is a convoluted web of 10 different agencies, each covering portions of consumer financial protection. It should consolidate the 10 agencies that currently oversee consumer financial protection, as the current system increases regulatory uncertainty.[3]

2.2 Protection

The second criterion by which to judge how well a CFPA would function will be its success in protecting consumers from abusive lending practices. It should have broad jurisdiction to protect consumers from abusive consumer financial products, including the ability to regulate non-bank lending. The CFPA should act as a floor to consumer protection standards, not a ceiling on states' potential regulatory efforts. Individual states have heterogeneous consumer lending markets, and should have the ability to create stricter laws that won't be preempted by federal regulators.[4]

2.3 Current Regulatory Efforts

The Obama white paper scores very well on both axes. The CFPA it proposes has broad jurisdiction and sole rule-making authority, while respecting state efforts through a lack of preemption.

HR 4173 had several loopholes added to it before it passed. Many lines of businesses were exempted from regulation under the CFPA, notably auto lending.[5] Federal preemption of state financial protection language was added.[6] But the CFPA passed with independence.

The current language in the Dodd Senate bill places the CFPA in the Federal Reserve. This Bureau of Consumer Financial Protection would have independent rule-making authority and financial independence. However the Financial Stability Oversight Council (FSOC) would have veto power over the Bureau if 2/3rd of its members find that the Bureau's actions increase systemic risk. It isn't clear why this veto power is necessary, and it reduces the independence of the Bureau. Raj Date has argued that the FSOC, as it was composed during the expansion of the subprime mortgages between 2003-2006, would have vetoed efforts to regulate the wave of prime interest-only and Option ARMs.[7]

3.0 Derivatives

Derivatives are complex financial instruments that are often traded in an opaque mark-to-model manner, commonly known as over-the-counter trading. Experts had warned that the current over-the-counter derivatives market structure couldn't deal with counterparty risk management, had no quality in disclosure and information for market participants and regulators, was rife with legal uncertainties and had no real official lines of defense against financial problems.[8] All these issues came to a head during the recent financial crisis.

All derivatives need to be transacted through an exchange with clearing. Those that can't be standardized to the requirements of the exchange should nonetheless pass through a clearinghouse. In addition, these

should have additional specific disclosure requirements for volume and price. The first axis by which to judge the financial reform of derivatives is to what degee derivatives are required to trade in clearinghouses, institutions that reduce systemic risk. The second axis measures to what degree derivatives are required to trade in exchanges, institutions that increase the transparency of the market.

3.1 Systemic Risk

A clearinghouse, in general, is an institution that becomes the opposite legal party for all derivate contracts. Clearinghouses are structured to regulate, monitor, and guarantee the obligation of the two parties who enter into a derivatives contract. They do this by handling the clearance and settlement of trades. The clearinghouse guarantees each trade, and interposes itself as the counter-party to both sides of every transaction.[9]

Clearinghouses are responsible for making sure those buying derivatives have posted the necessary collateral. This collateral will be used to hedge against the counterparty risk that the person on each side of the derivative exchange will not be able to make good on their obligation.

3.2 Transparency

What are the advantages of an exchange? One is pretrade price transparency. This is a structure in which multiple parties can see and execute offers from other parties. Exchanges can collect prices at which multiple parties would be willing to trade at a moment in time and update those prices as time passes. Aggregate level information about prices, volumes and open interest to market participants and the general public.

A problem with clearinghouses is that they see only one price, the price at which the deal was struck, and they only see that price after the deal is completed. This is only a partial history, and it lacks real information that the market can use. A fuller price history will give us information available for use by many different parties to carry out their own transactions, the very heart of what prices are supposed to do in a market.

This price history can be used to make sure that the regulatory structure itself is well capitalized, using market prices versus the collateral being held. This will help eliminate the Too Big To Fail problem that the clearinghouse itself would have.[10]

This price transparency should lead to lower transaction costs, as market participants can compete for narrower spreads by offering better deals on the sell-side, and for smarter price shopping on the buy-side. As a Sanford C. Bernstein & Co. analyst has said, the more actively traded the contracts become on an exchange and the more transparent prices get, the narrower the spread becomes. There are fewer economic rents, and markets become more efficient, and there would be major savings through lower transaction costs.[11]

Another benefit is that a high-resolution audit trail gives managers and regulators something to investigate and a way to observe performance. With this audit trail, managers can more easily catch traders who try to game a bonus structure in which they win on the upside and the shareholders lose on the downside. This helps to resolve the obvious principal-agent problems that we see with the bonus culture on Wall Street. More importantly from a public policy point of view, regulators get a clearer view of both corruption and systematic financial risks after the fact, making detection easier and thus increasing a deterrence effect.

Regulators should limit the number of exchanges and clearinghouses. One of the duties of clearinghouses is to net the exposures of derivative contracts, and derivatives can't net across clearinghouses. Competition between clearinghouses can also lead to competition with collateral posted, leading to a situation where clearinghouses are undercapitalized relative to the risk they need to handle.[12]

A reasonable problem is that some contracts can't be standardized to trade on an exchange. Exemptions should be made for those who are offsetting and hedging risks, particularly "end-users" who are not using derivatives for speculative purposes. These exemptions should have similar capital requirements than similarly traded instruments on exchanges, in effect paying a tax to society for the complexity and uncertainty imposed on the financial system by such contracts.

In addition, transparency will be necessary for both market participants and regulators. Real time trade-level information on volume and prices that has the identity of buyers and sellers removed is essential for the derivatives that will still remain off exchanges. This will be similar to such market innovation as TRACE, in the corporate bond market.[13] Recent research has found that TRACE has benefitted public traders significantly in terms of lower transaction costs as a result of even this level of price transparency.[14]

3.3 Efforts

Derivatives reform has been a major piece of the reform efforts.[15] The Obama's administration's original white paper proposed that all standardized OTC derivatives be subject to clearing and exchange trading, in accordance with the traditional dictates of market regulation that had been in place since the New Deal.

On August 11th 2009, the Treasury department created significant loopholes in the derivatives language that was submitted to Congress. Foreign exchange swaps and foreign exchange forwards would be excluded from proper regulation by the CFTC. Exemptions were also put into place that required mandatory clearing and exchange trading for non-banks, and also recommended the preemption of state gaming and anti-bucket shop regulation.

These new loopholes significantly weakened the original strong language of the derivatives bill, and the Obama's white paper placement on the derivatives grid reflects this new language.

HR 4173 had three extra loopholes in the final language of the bill. The exchange trading requirement could be satisfied by placement on a swap execution facility, weakening the very notion of what an exchange is. Abusive swaps could no longer be banned. And state insurance laws are further preempted.

The Senate bill has been submitted, and it retains much of the language of the white paper's original excellent language for derivatives. However, in the manager's amendment the Financial Stability Oversight Council is capable of voting to allow end-users to not comply with the derivatives regulation. It is uncertain how much the Council will use that power to keep the derivatives market deregulated.

4.0 Resolution Authority

Resolution authority is the ability to unwind a systemically important financial firm through means other than the bankruptcy code.[16] During the financial crisis of Fall 2008, regulators found that they lacked the legal authority they needed to wind down financial institutions.

Regulators need to be able to detect systemically important financial firms that are going to fail beforehand, and use the financial sector's regulatory powers to push them back on a stable path. So resolution isn't just about failing a firm, it's about taking steps to tell a firm that it must take action to become safer before it is resolved.

The legal authority is important. But ideally we'd like to not use it, in the same way that we prefer not to wind down FDIC insured banks. So it is important to think of resolution authority as existing on two axes: one of deterrence and one of detection.

4.1 Detection

Detection is the ability to determine whether or not a financial firm is in trouble. Resolution isn't just a legal process at the time of bankruptcy. It's about the period right before the firm starts to spin out of control, where regulators can see that the books are starting to look weak. At this point, regulators can demand that financial firms raise more capital, divest of certain business lines, and make themselves less interconnected. This is essential for financial firms because as they get closer to bankruptcy, they have more incentives to gamble big and hope that it pays off, leaving more costs to the real economy. Post-1991, this is done for commercial banks through a process called prompt corrective action. This involves both written rules on when to start winding down firms and rules on when to resolve the firm. In-between these two points regulators have discretion on how to apply their regulatory authority. This process is optimal to help resolve the bad incentives regulators face.[17]

Now in order to invoke early remediation, you need to be able to detect problems. One way to do this would be for to have derivatives reform, which is treated as a separate topic. Another step is balance sheet reform,[18] much-needed reform in light of recent reports about scandals on Wall Street.

A final step is to have extensive real time examination and international exposure information. This map of exposures needs to show the pattern of exposures around the world of the largest systemically important financial markets, updated frequently.[19]

4.2 Deterrence

The other axis is deterrence. This is a rule-based approach designed to prevent the occurrence of problems that need to be detected. Increased capital ratios are one such deterrent. Capital ratios reduce leverage in the financial system and provide banks with a greater cushion for difficult times. Interconnected limits are an additional deterrent to another financial crisis. Preventing large financial firms from being too tied up with other specific large financial firms will lead to fewer cascading failures.

Other elements of deterrence are required events that happen when resolution authority is invoked. The forced resignation of management in the case of resolution will cause deter risky behavior. Mandatory haircuts of not less than 15% of qualified financial contracts, along with mandatory equity dilution or wiping out of equity, will help with financial firms wanting to avoid resolution.

4.3 Efforts

The Obama white paper included language on identifying firms that are systemically risky to the entire financial system and giving regulators the powers necessary to resolve them. It proposes international reforms, including oversight of global financial markets.

HR 4173 provides a resolution authority to unwind large systemically risky financial firms. It calls for international harmonization of financial regulatory regimes and the sharing of international trading data. HR 4173 also has hard limits on leverage, with a maximum 15-to-1 ratio.

The Dodd Bill follows a similar path. The Dodd Bill has early remediation requirements replacing the language of prompt corrective action. This is triggered during "the initial stages of financial decline." We want regulators to be able to intervene while there is still a chance that the business is salvageable. It contains no hard limits from the legislation in terms of leverage.

5.0 21st Century Glass-Steagall

In the previous financial crisis, our economy was subjected to a bank run on a new type of "shadow banking" system centered on lending in the repo markets.[20] These are markets where investment banks provide liquidity through the highly efficient buy very confidence-sensitive wholesale markets to very illiquid commercial and consumer credit. This mismatch in liquidity can be subject to a bank run.[21]

These new types of firms, the shadow banks, were created as a result of two specific regulatory arbitrages: a capital arbitrage and a liquidity arbitrage. The two axes for evaluation whether or not the shadow banks are being regulated in a way that no longer threatens the financial sector is whether or not proper prudential banking regulation is brought to the shadowing banking sector, and whether or not there is transparency brought to the individual parts of the shadow banking system.

5.1 Banking Regulation

Financial firms were able to take on a large amount of risk because they weren't capitalized as if they were commercial banks. They had significantly more leverage than their banking counterparts. And unlike commercial banks, they were never tested to make sure they could properly survive a shock to their liquidity stock.

So removing these two arbitrages is a baseline requirement for fixing the financial system. Requiring systemically important financial firms to be capitalized with higher standards than less risky banks is essential. Also, specific stress testing of liquidity position, as well as regulators' specific observation of liquidity positions more generally will help with the financial reform. Size caps on the overall size of banks would also be a way to make sure resolution authority worked well. Size caps could function as a new form of banking regulation that strengthens all the other banking regulation.

5.2 Transparency

There are many parts of the shadow banking system that are quite opaque. The securitization process, along with the failure of the ratings agencies, created a large amount of debt that was difficult to value when a crisis came in, further decreasing its liquidity. Consumers were poorly informed of the debts they were taking on, so reforms of abusive lending practices are essential. Derivatives were used to insure the debt being used as collateral, so derivatives reform is crucial. And overlapping banking business models can cause conflicts of interest, as well as make it more difficult for regulators to do their job, so a Volcker Rule to split proprietary trading from commercial banking is important. And finally, to make sure we are not expanding the scope of guarantees, it is necessary to have strong resolution authority.

Consumer financial protection, derivatives reform and resolution authority are covered elsewhere. The transparency axis will specifically refer to legislation that brings transparency to the shadow banking business model, specifically off-balance sheet reform, ratings agencies reform, and securitization reform, as well as provides walls between business lines, like the Volcker Rule.

5.3 Efforts

In Obama's white paper, there are specific calls for the prudential standards for Tier 1 HFCs to have "stricter and more conservative" capital, liquidity and risk management standards. There is a call to increase the regulatory framework of market money mutual funds to prevent them from being subject to runs.

The white papers argues that new regulations for originators and sponsors of federal banking agencies should

retain an economic interest in a material portion of the credit risk of securitized credit exposures. Regulators should reduce the use of the credit ratings agencies. There is a call for increased efforts for transparency and standardization in the securitization markets, and the SEC has clear authority to require reporting.

HR 4173 establishes a Credit Ratings Agency Advisory Board, consisting of seven members who will be given oversight on the ratings agencies. There are additional requirements related to differentiation.[22] Companies that issue securities would retain at least 5% of the credit risk, and the SEC regulations must require issuers of asset-backed securities to disclosure asset-level data.

In the current Senate Bill there is language to discourage the excessive growth and complexity of the financial system. There will be regulation towards liquidity provisioning. There will be a commission that investigates the effects of implementing the Volcker Rule, which a risk council will choose to implement or not at a later date. There will be reforms of the credit ratings agencies that would help bring competition and transparency to that market.

6.0 Conclusion

The Senate bill is lacking in many of the essential areas for reform. Here are specific, targeted ways of strengthening the Senate bill:

- Hard limits related to both size caps relative to GDP and leverage ratio must be specified in the bill. This will put a floor to the difficulty of resolution and the damage to the economy.
- The Volcker Rule should be accepted outright, rather than through the decision of the Financial Stability Oversight Council.
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Talking Points

- There is too much discretion in the Senate Financial Reform Bill. Some hard numbers, like absolute leverage requirements or size caps relative to GDP, should be written into the legislation like in the House Bill. We shouldn't expect regulators to be perfect, but mostly to carry out simple rules.
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Endnotes

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2. For more on creating a CFPA, see Elizabeth Warren, "The Broken Consumer Credit Market", *Make Markets Be Markets* conference.
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4. See Robert Berner and Brian Grow *BusinessWeek,* "They Warned Us About the Mortgage Crisis" October 9th, 2008.
5. See Raj Date, "Auto Race to the Bottom: Free Markets and Consumer Protection in Auto Finance", Cambridge Winter research note, November 16th 2009.
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7. See the analysis of the FSOC board members' opinions of the housing market in 2003 in Raj Date, "Losing the Last War: Evaluating Veto Powers on Consumer Financial Protection", Cambridge Winter Center, March 21st 2010.
8. For an early warning of these problems, see Garry J. Schinasi, et al (2000) "Modern Banking and OTC Derivatves Markets: The Transformation of Global Finance and its Implications for Systemic Risk," International Monetary Fund, especially Conclusion.
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10. See Acharya, et al (2009) "Centralized Clearing for Credit Derivatives" in NYU Stern's Restoring Financial Stability for more on the advantages of exchanges.
11. See Elizabeth Hester (2009) "JPMorgan Derivatives Revenue May Drop By $3 Billion" Bloomberg.
12. See Squam Lake Working Group on Financial Regulation (2009) "Credit Default Swaps, Clearinghouses, and Exchanges", and Darrell Duffie and Haoxiang Zhou (2009), "When Does a Central Clearing Counterparty Reduce Counterparty Risk?" Working Paper, Graduate School of Business, Stanford University.
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15. For a more on the reform of derivatives during the Obama administration, see Michael Greenberger "Out of the Black Hole: Regulatory Reform of the Over-The-Counter Derivatives Market", Make Markets Be Markets conference.
16. For more on how a full system of resolution authority should work, see "Credible Resolution: What it Takes to End Too Big To Fail?" by Robert Johnson, from the *Make Markets Be Markets* conference.
17. For more on this issue, see "Regulator's Incentives" by Richard Scott Carnell, *Make Markets Be Markets* conference.
18. For more on this issue, see "Bring Transparency to Off-Balance Sheet Accounting" by Frank Partnoy and Lynn E. Turner, *Make Markets Be Markets* conference.
19. See Garry Schinasi, Safeguarding Financial Stability: Theory and Practice (Washington, DC: International Monetary Fund) 2006, and "Regimes for Handling Bank Failures: Redrawing the Banking Social Contract by" Paul Tucker, Deputy Governor of the Bank of England.
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23. See analysis in "House Passes Historic Securities, Derivatives and Systemic Risk Reforms: HR 4173", James Hamilton, J.D., LLM.

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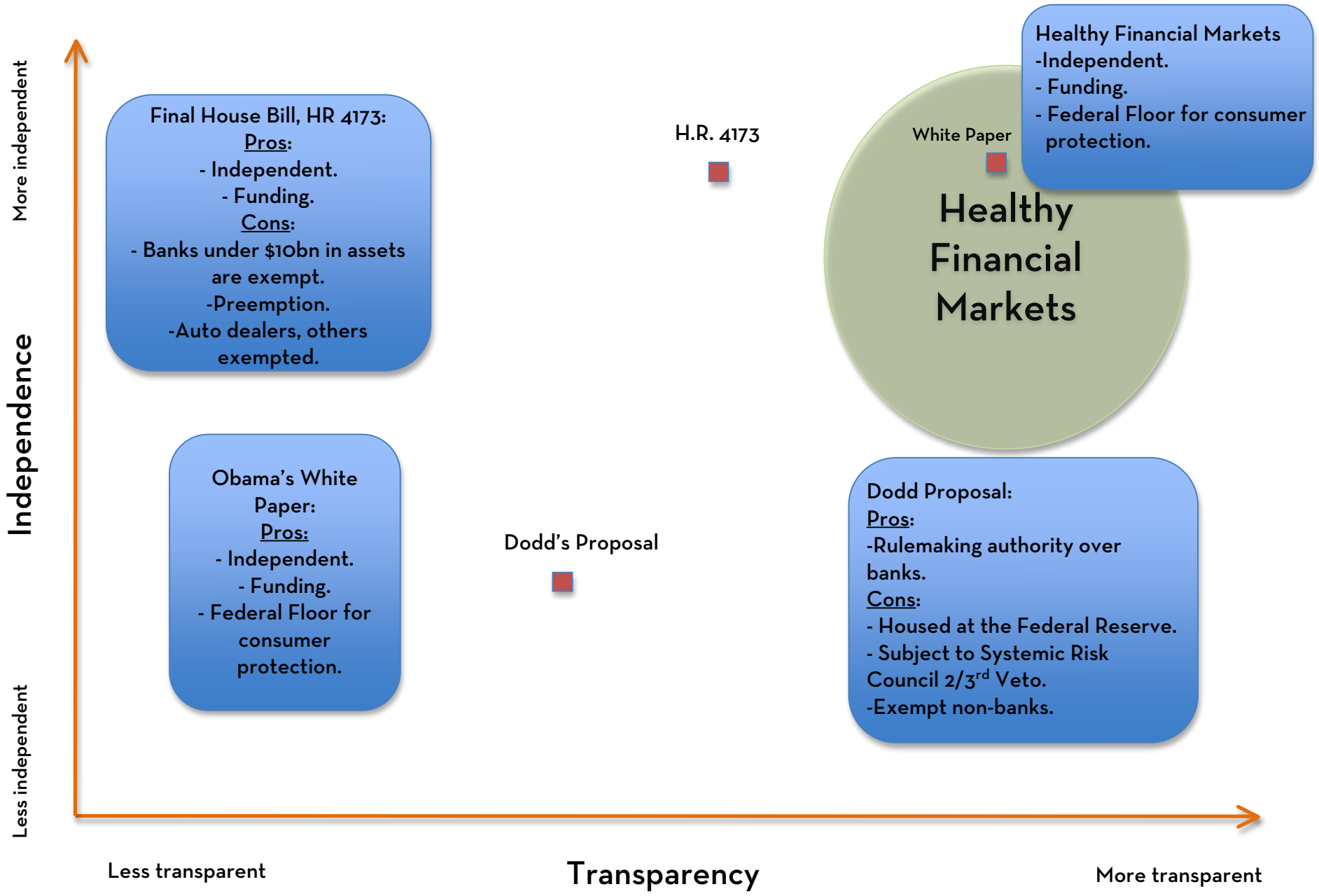
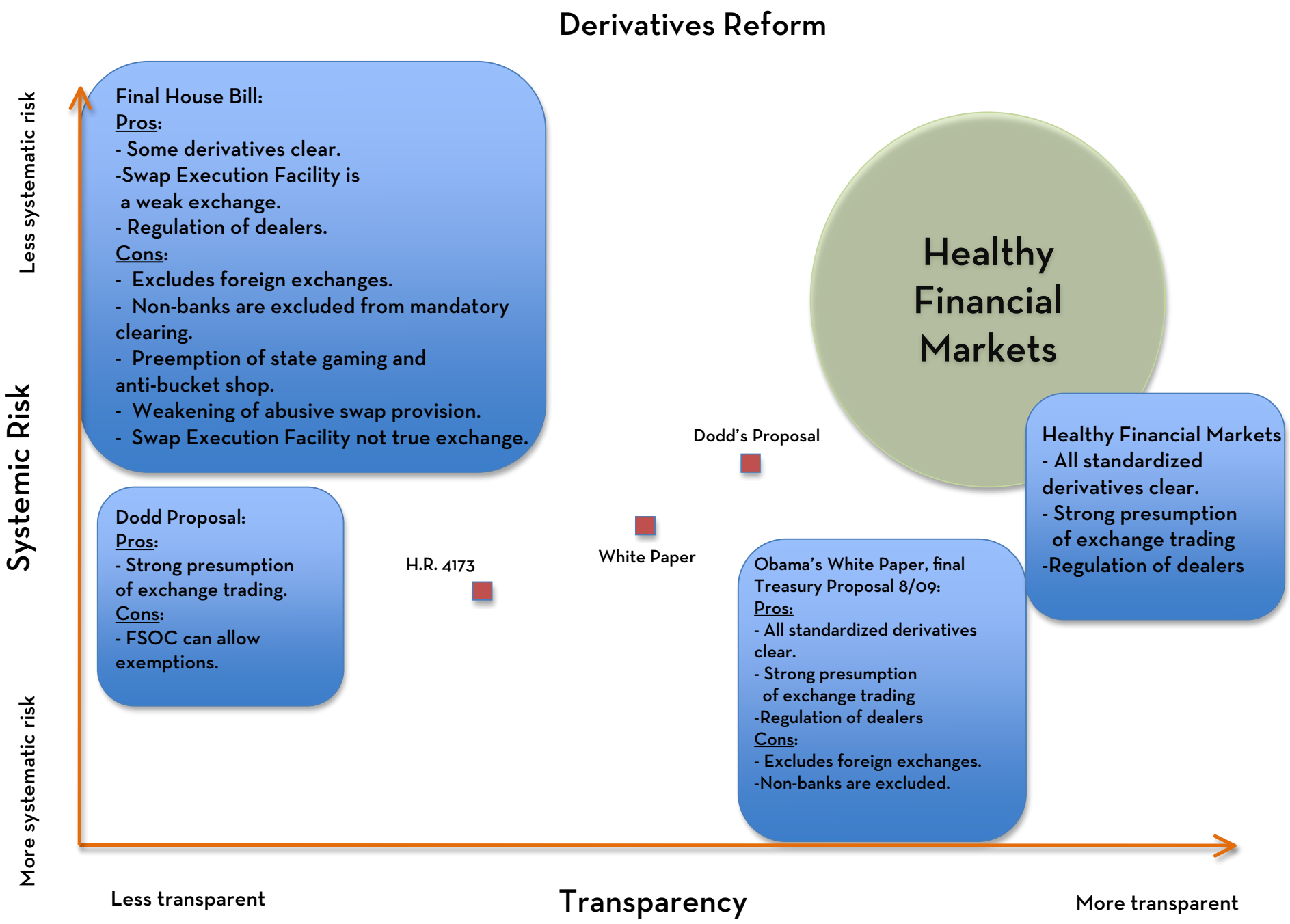
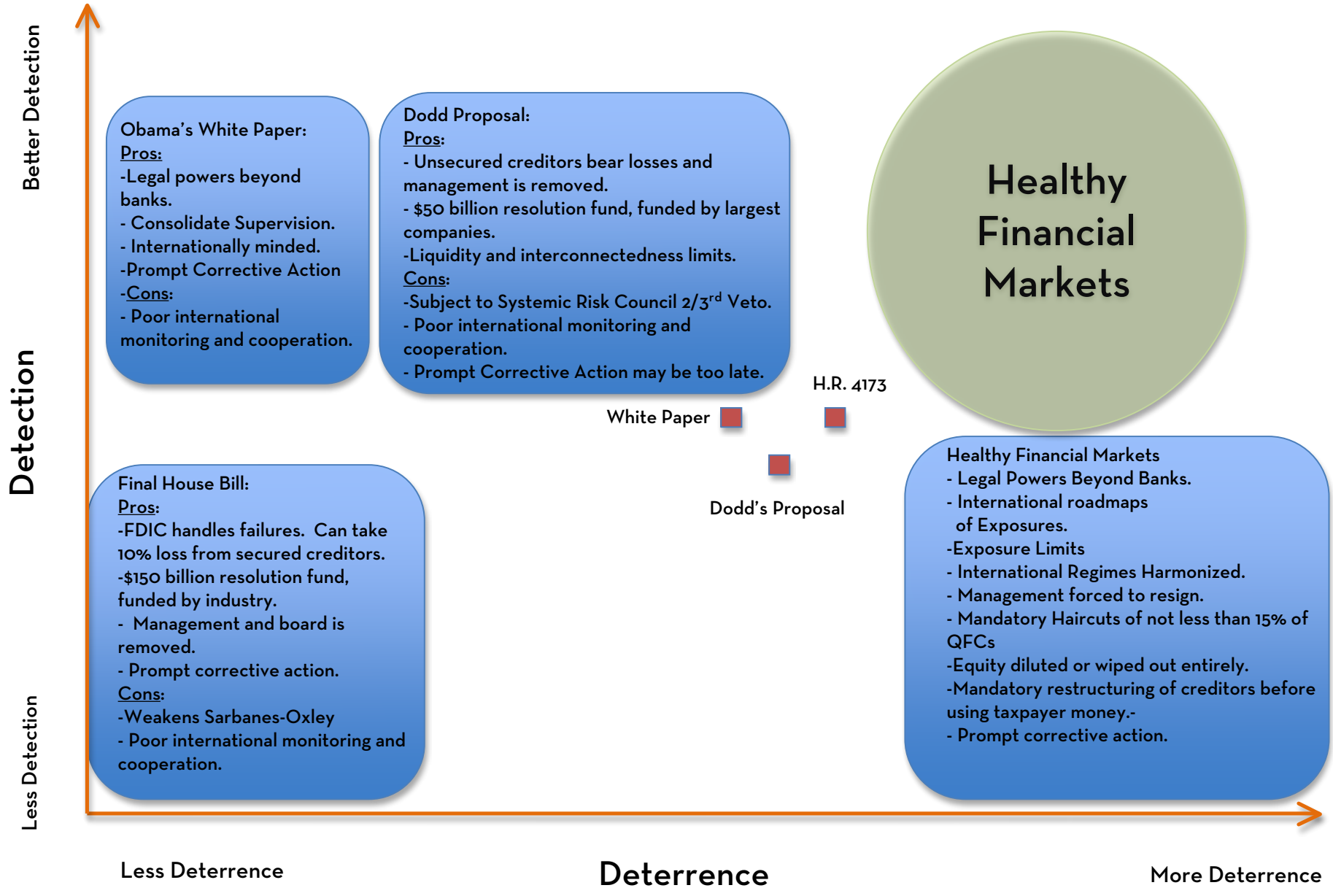
Consumer Financial Protection




Derivatives Reform
Systemic Risk
Less systematic risk
More systematic risk
Transparency
Less transparent
More transparent
Final House Bill:
Pros:
- Some derivatives clear.
-Swap Execution Facility is a weak exchange.
- Regulation of dealers.
Cons:
- Excludes foreign exchanges.
- Non-banks are excluded from mandatory clearing.
- Preemption of state gaming and anti-bucket shop.
- Weakening of abusive swap provision.
- Swap Execution Facility not true exchange.
Dodd Proposal:
Pros:
- Strong presumption of exchange trading.
Cons:
- FSOC can allow exemptions.
H.R. 4173
White Paper
Dodd's Proposal
Obama's White Paper, final Treasury Proposal 8/09:
Pros:
- All standardized derivatives clear.
- Strong presumption of exchange trading
-Regulation of dealers
Cons:
- Excludes foreign exchanges.
-Non-banks are excluded.
Healthy Financial Markets
Healthy Financial Markets
- All standardized derivatives clear.
- Strong presumption of exchange trading
-Regulation of dealers

Resolution Authority



21st Century Glass-Steagall