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Grading Financial Reform

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Last week, the U.S. House of Representatives passed the Wall Street Reform and Consumer Protection Act, HR4173, which is arguably the most significant revision of our financial regulatory system since the 1930s.

Soon, probably early in the new year, the United States Senate will begin debating the Restoring American Financial Stability Act, a comprehensive financial reform bill that tackles the same issues. Both bills cover many issues and take some different approaches. Together with a number of colleagues from the NYU/Stern Working Group on Financial Reform, we have analyzed and commented on the details of the proposed legislation and will continue to do so as it evolves. Here we offer some highlights on the bill passed last week.

Perhaps most surprising is that the media paid so little attention to these far-reaching reforms. But this is the "balloon boy" world we live in. When the media did focus on the reforms, it was strictly on sideshow issues of executive pay and consumer protection.

Our view is that consolidating consumer protection and engaging in a serious effort to improve financial literacy are valuable goals. The legislations itself, however, is full of carve-outs that would leave many of the most important parts of the consumer financial market place unregulated.

Much of the focus on compensation is also somewhat misdirected. Compensation at financial firms is substantially share-based, so the interests of managers and shareholders tend to be closely aligned. Indeed, top employees at these firms incurred enormous losses of personal wealth in the crisis. The bigger problem for regulators and society is that because of implicit and explicit federal guarantees, the incentive to take large, potentially systemic risks is built directly into the equity itself.

The House bill does address the most important problems of regulating systemic risk and too-big-to-fail institutions directly--make no mistake about it. Guaranteeing the liabilities of major U.S. financial institutions distorts the allocation of capital and competition among financial intermediaries. The guarantee provides these firms with an unfair advantage, because they can raise capital at a lower cost. Since the guarantee is so valuable and pervasive, these giant intermediaries face little market discipline and have a perverse incentive to expand their scope, scale, risk exposure, leverage and financial interconnectedness. The result is a less-competitive and less-efficient financial system.

The good news is that the Congressional bills seem to be on the right track. If the legislation is implemented as written, then there will be a full frontal assault on too-big-to-fail institutions. Specifically, the bill advocates: (i) charging the firms premiums for systemic risk; (ii) imposing higher capital and liquidity requirements; (iii) restricting proprietary trading activities if deemed necessary to limit risk; and (iv) forcing the issuance of contingent capital, which will bring back market discipline and shift some of the risk from taxpayers back to creditors. One disappointment, however, is the mechanism the bill sets up for failed systemically significant financial companies. While providing the legal authority to the regulator is a step in the right direction, the legislation does not go far enough to reduce the uncertainty surrounding bankruptcy.

Less successful are the proposals to regulate derivatives. An important reason why some financial institutions became too big to fail in the recent crisis was that they were too interconnected to fail--regulators and markets did not have sufficient information on the exact nature of these links. Many of these connections had to do with positions in over-the-counter derivatives such as credit default swaps (CDS). Besides this issue of opacity, OTC derivatives are also potentially a mechanism for banks to avoid the more stringent margin- or collateral-requirements they face when similar products are traded on exchanges or clearinghouses.

The bill unfortunately succeeds only partially in addressing these issues. On the positive side, it does require that all OTC positions be reported in a centralized data registry with full regulatory access. This should allow regulators to prepare better for future failures of financial firms. It appears unlikely, however, that market transparency will be enhanced other than through provision of aggregated position information. Negatively speaking, the bill does not mandate centralized clearing of OTC derivatives except when a clearinghouse is willing to accept them. While regulators would review products for possible clearing, ultimately clearing houses are run by participating dealers. Hence, it appears that the bill leaves considerable, perhaps almost all, discretion to financial firms as to which products will be centrally cleared.

Failure to move CDS--even the standardized ones--to central clearing was a key contributor to the crisis: CDS clearing, a "utility" function, remained inside Bear Stearns, a private risk-taking firm, and so when Bear collapsed, there were widespread fears of contagion through CDS interconnections. Therefore the bill is at best disappointing and lacks sufficient conviction in addressing the systemic risk issues relating to OTC derivatives.

The House bill would alter the ability of the Federal Reserve to function as effectively as it has in the recent crisis. Maintaining the Fed's role as an effective lender of last resort is vitally important. Although the proposed legislation leaves the Fed's traditional lending facility intact, both the Senate and House proposals would inhibit the ability of the Fed to conduct such lending.

The Senate proposal would remove all bank regulatory and examination functions from the Fed. If that happens, the Fed would have no reliable way of monitoring or evaluating potential borrowers at the discount window. Although the legislation allows the Fed to request information from a new regulatory agency or to ask to participate in examinations, it would be far removed from information regarding potential borrowers and ill-prepared to make sound judgments about them. Under the House bill, the Fed has a continuing role in financial regulation, but the Chairman of the Board is only a member of the new systemic regulator, the Financial Services Oversight Council, which would determine when emergency lending by either the Fed or the FDIC is warranted.

There are elements of both the House and Senate proposals that would politicize monetary policy and crisis management operations of the Fed in ways that could easily prove counterproductive to economic stability. Both bills call for reviews or audits of lending programs introduced in response to the crisis with only limited restrictions on maintaining the confidentiality of information. The House bill, which now incorporates provisions of the Paul-Grayson amendment, calls for an immediate and extensive audit of the Fed's responses to the crisis and also removes the exclusion of monetary policy deliberations from regular audits in the future.

The Fed has fought for decades to achieve and retain that independence, but it has seriously pushed the envelope in managing the financial crisis. It will be a hard slog to preserve independence but one that is well worth the effort. The last thing a credible central bank needs is dog's breakfast of monetary policy, macro-prudential and micro-prudential, all the while under intense lobbying from special interests who have a great deal at stake.

There is going to be a long debate early in the new year that will determine how these and many other issues play out. We will continue to provide commentary here as the issues unfold.

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