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The Race To Finish Financial Reform

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We are on the threshold of the most ambitious overhaul of financial regulation since the 1930s. Last week the Senate passed the *Restoring American Financial Stability Act* (RAFSA), which must now be reconciled with the House version of financial reform, the *Wall Street Reform and Consumer Protection Act* of 2009. There are some significant differences between the two bills and those differences are going to be the focus of a huge lobbying effort as Wall Street tries to shape the final outcome. The stakes are very big.

Much of what is at issue in these bills is fairly arcane. It is potently sleep inducing for the average American, but it is critically important for the future stability and vitality of our financial system. How do we prevent the kinds of outrageously risky behavior that drove us to the brink of depression without discouraging the kinds of innovations that gave almost everyone better access to credit and better tools for risk management? The bills tackle a very broad set of issues, from consumer protection to executive compensation to the structure of the ratings industry. But there are three areas that are important for future financial stability, which are critically important for Wall Street and where the House and Senate versions differ. These are the regulation of credit derivatives, provisions to mitigate system risk and the problem of firms that are too big to fail.

One of the critical issues addressed by the bills is the regulation of derivatives. Credit derivatives have been one of the most important and complex areas of financial innovation over the past several decades. They allow firms to manage their risks in a way that wasn't possible in the past. But they are also tools for speculation. Most derivatives are traded over the counter (OTC) and as a consequence they are not at all transparent. Their opacity was a contributor to the financial crisis because it was very hard to figure out the counterparty risks in the system.

Both the House and the Senate bills address the opacity problem by requiring that many standard derivative contracts be traded on exchanges. The bills would continue to allow over the counter trading of "bespoke" or customized derivative contracts subject to regulatory approval. The contentious provision is an amendment the Senate bill, authored by Sen. Blanche Lincoln, which would prohibit depository institutions from operating their own derivatives trading operations. This is a very bad idea. Financial firms are in fact the most important end users of OTC derivatives. For instance, the largest trading in OTC derivatives is in interest rate swaps which are used by commercial banks large and small the world over to manage interest rate risk arising from duration mismatch of assets and liabilities. Forcing those activities out of banks would only make that hedging more inefficient. It is an example of intrusive regulation with a real purpose. It seems very likely to be deep-sixed in the reconciliation process.

Another big difference between the two bills is in their approach to regulating systemic risk. In a nutshell, the House version proposes to tax systemic risk to discourage banks from creating it and create an insurance fund to cover the costs of resolving failing firms. The Senate bill proposes limiting the functional scope of banks activities. It is only natural that the large financial institutions view a bank tax as anathema. They fought vigorously to have it removed from the Senate's initial version of RAFSA.. And, the Republicans and the conservative punderati portrayed it as a bailout fund that would, in the end, create more moral hazard. The argument is that, with such a fund, regulators would find it irresistible to use it to save the creditors of failing institutions.

But here is another way to think about it. It is insurance, just like the FDIC deposit insurance fund that is designed to cover the costs of winding down or restructuring failed banks. This fund would be used to cover the costs of winding down or restructuring failing systemically risky firms that have until now been deemed too big to fail. The house bill proposes a $150 billion fund. RAFSA originally proposed a $50 billion fund. That is gone but replaced with the proviso that surviving banks would be assessed ex-post for the costs of winding down failed institutions.

How sensible is that? It implies that the financial burden would fall most heavily on the least risky, best managed, banks. And it would fall most heavily on them in crisis situations where all banks are under stress. In fact, imposing costs ex-post will only exacerbate the moral hazard. Institutions have more incentive to gamble because the costs of loosing big will be born by the survivors. In a situation like that it is easy to imagine that the banks would plead for special consideration and once again the taxpayers would be called on to foot the bill.

The alternative to charging insurance premiums for systemic risk is to try to limit the potential costs in other ways. This is where the "Volcker Rule" comes in. It was not a part of the House bill even though Paul Volcker had been vocally advocating restrictions on the activities of banks for months. The logic behind the Volcker Rule is this: Using the taxation approach to encourage market discipline to limit risky behavior is too abstract, too difficult to implement (it is not) and politically infeasible. Given that view, the best strategy for limiting risk is to circumscribe the activities of banks by banning proprietary trading. Of course identifying what is proprietary trading presents its own difficulties and the proposed legislation seems to offer wide latitude.

If the debate is framed correctly, it may well come down to that choice--no proprietary trading or a systemic resolution fund financed in advance. It seems to me that the banks and the country would be better served by the latter. If they up with neither option, they will have set the table for the next crisis.

A critical component with either choice is to have resolution mechanisms in place to address the problems of failing banks. Contingent capital--debt that converts to equity when capital requirements are breached--and "living wills" are both innovations that will limit the likelihood of disorderly failure. But these will be battlegrounds as well. Banks want to treat contingent capital as counting toward their regulatory capital requirements. If that were to happen they would be undermining the intent and getting subsidized leverage because they get interest deductions on the contingent portion of their capital.

There are major issues that are not addressed--what to do about Fannie Mae and Freddie Mac and mortgages more generally. There will be other battles centered on narrower issues, like legislating fees on credit and debit cards and other details of consumer protection. How these are resolved will impact the availability of consumer credit because they represent the intrusive side of regulation. Good regulation is always a balancing act--trading off the containment of socially costly behavior against the incentives to innovate. Unfortunately, a lot of these tradeoffs will only get resolved in the last mad rush to complete the legislation. As with health care reform--this is not a recipe for sound decision making.

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