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Punting the Bill:
Heading into Overtime in the Game of Financial Industry Regulatory Reform

The below essay on the current status of financial industry regulatory reform legislation was published by ***The New York Times*** *earlier today, as part of its Dealbook blog, edited by Andrew Ross Sorkin. Please do not hesitate to offer comment at the Times' link below.*[1]

Overview

Congressional proponents of necessary reregulation of our financial services industries received a break as the European credit crisis has sent the markets on another retreat from risk, and the zeitgeist is taking a break from the V-shaped recovery crowd. Accordingly, in May, the U.S. Senate was able to pass an omnibus bill that is significantly more far reaching than anything that could have emerged from the dysfunctional legislature only a few months before.

That S. 3217—the Restoring American Financial Stability Act of 2010 (have all the good names for laws been taken?)—covers more than many pundits had thought politically possible is certainly remarkable. Nevertheless, it has been well over a year in coming since the credit crisis' nadir and, of far more interest to those attempting to understand the bill's implications, is chockablock with "punts" to the regulations that will follow once the bill is enacted into law.

Politically, it turns out, the Senate bill owes its surprisingly robust content to its ambiguous scope: 1,566 pages that don't really address how the landscape of our financial system will look. To move the legislation through the various committees that came together to promulgate it, onto and off of the Senate floor (and ultimately, over the next several weeks, through conference committee to pair it off with an even less specific bill, H. 4173, passed by the House of Representatives in December), both the Senate and House effectively leave most of the heavy lifting to future study and regulation-writing by a host of new and existing regulatory bodies. Among the issues left for future resolution are, alas, several of the most important matters concerning the reregulation of this nation's financial sector, as follows:

Required Equity Capitalization of Large Banks and Non-banks

The legislation produced by both houses of Congress implicitly accepts the existence of very large financial institutions that, if continue to remain under-regulated, would give rise to future systemic threat if one or more of them were to fail. The bills seek to address the concept of "too big to fail" not by attacking bigness (although they pay some lip service to the notion), but by limiting the possibility of failure and by

[1] http://dealbook.blogs.nytimes.com/2010/06/02/another-view-punting-financial-reform/

establishing a protocol for winding down teetering institutions with minimal government support. We agree, and have consistently stated, that limiting bigness would have a far greater impact on U.S. banks' competitiveness and the vibrancy of domestic credit markets than would a raft of prudential regulatory initiatives. Nevertheless, we also believe that the most important defense against future crises is the relatively simple implementation of increased capital requirements for larger financial institutions.

The Senate bill speaks to this by requiring the new Financial Stability Oversight Council (FSOC) to study the issue and recommend new regulatory requirements to the Federal Reserve Bank. The bill also addresses the issue of limiting which forms of GAAP equity capital can be included in Tier 1 and other computations of regulatory capital but, again, the impact will be unclear for many months after the president signs the final bill into law. We would like to see a limited definition of eligible Tier 1 Capital set between 15% and 18% of total capitalization for banks with assets in excess of $50 billion. The larger the institution, the higher the capital requirement. At the heart of this issue is the continuing conflict between:

- The interests of the government that charters and provides liquidity and deposit insurance to banks (and the taxpayers to whom government answers); and
- The interests of financial companies in being as profitable to their shareholders (which invariably means seeking more leverage and holding less equity capital).

This, in our opinion, is the single most salient issue in determining whether the reregulation of the financial sector is ultimately successful in preventing a recurrence of what we have just lived through.

Proprietary Trading and the Volcker Rule

One of the most controversial issues underlying financial reform is defining the appropriate business activities of systemically critical, government-chartered and -insured financial institutions. Prior to the elimination of the Glass-Steagall restrictions, commercial banking was a relatively boring, generally well-capitalized business that could really get itself into trouble only by making bad loans (which could usually be worked out over time). Securities firms—lacking the ability to raise capital by taking insured deposits without access to the Fed's discount window and, for much of their history, private partnerships—placed far smaller amounts of their capital at risk at any given moment and operated with dramatically less leverage than they have since the Glass-Steagall restrictions were lifted. Since then, banks and investment banks have competed head to head across virtually all business lines, with chartered banks having the enormous advantage of essentially borrowing money cheaply (taking deposits) backed by the guarantee of the FDIC. The only way non-banks could compete was by borrowing money from the rest of the financial system at greater cost and systemic risk.

As unattractive as that sounds, it was, in fact, a primary underlying reason for the financial crisis. As a direct result of that ciris, our large, systemically critical investment banks have either become or been acquired by commercial banks. This leaves us with the problem of having to evaluate which of the business lines of the former investment banks are appropriate for a chartered commercial bank with federally guaranteed deposits and recourse to the Fed. Implicit in FDIC insurance and the ability to draw upon central bank liquidity—to say nothing of large banks' ability to threaten the global financial system, should they fail—is the notion that the government/taxpayers could (let's just say, would) end up on the hook if they go under. Preventing the failure of "too big to fail" banks is not only a balance sheet issue (as with the capital requirements discussed above), but clearly also involves restricting the activities in which banks can engage. Again, both the Senate and House bills essentially punt on this issue, expressing the need for regulators to limit risky proprietary trading activities (the so-called Volcker Rule, named after our most venerable post-war Fed chairman, who has had the courtesy to live long enough to be an invaluable voice in the post-crisis debate), but without defining exactly what those risky activities are or even how to delineate between which activities are undertaken for a bank's own account and those undertaken in the service of its customers. Until Volcker Rule regulations are promulgated, we won't know the shenanigans from which the banking sector will be barred—a critical step in containing systemic risk.

Regulation of Derivatives Origination and Trading

Just as the faded, but still attractive, Blanche DuBois clashed with Stanley Kowalski in *A Streetcar Named Desire*, so has another (albeit much younger) southern Blanche (Lincoln) been thrown under the streetcar last week by another tough guy (don't ask!): Barney Frank. Sen. Lincoln has been understandably outraged by banks using their prodigious balance sheets to act as bookies in financial side bets on propositions reckoned to be in the hundreds of trillions of dollars—many of them wagers that offer little in the way of economic benefit, other than making sure that those on the winning side can conspicuously consume luxury goods. Unfortunately, a number of our systemically critical financial institutions failed to fade the "action" they took in the years leading up to the financial crisis and went all-in with money that was apparently no one's—except, as things turned out, the U.S. taxpayers'. And, wouldn't you know, as chair of the Senate Committee on Agriculture, Nutrition and Forestry (again, please, don't ask!), Sen. Lincoln is responsible for legislation that deals with derivative contracts. She came up with an interesting solution to avoiding the systemic risk posed by banks that issue the most risky forms of derivates unconnected with other economic activities: Ban them from doing so.

House Financial Services Committee Chairman Frank didn't see the need for such restrictions in the House version of reform legislation and seeks to scuttle them. His logic seems to make sense at first blush: The Volcker Rule will limit proprietary trading and therefore (by derivation!) the most noxious forms of derivatives exposure. Impeccable reasoning, but for the fact that neither the House nor Senate versions of the bills define exactly what banks' proprietary activities are and which practices will be verboten. Perhaps "fading" clients' derivative bets will be deemed a permitted business by regulators? On the other hand, the regulators (the FDIC's Sheila Bair and the Fed's Ben Bernanke) are on record as saying they very much want to keep whatever is left of the derivatives industry within the banking system so it can be effectively regulated by their entities. Again, the devil is in the details, and the ongoing kerfuffle over Sen. Lincoln's solution is an example of what happens in Washington when legislation gets too specific (if one excludes earmarks from that statement), making consensus impossible.

Credit Rating Agency Reform

While they have been all but tarred, feathered and run out of town in Washington, the major rating agencies have not yet been held accountable, financially or operationally, for having been both asleep at the switch and ethically compromised during the credit-driven bubble era. Both the Senate and House bills include language that broadly expands regulatory oversight of the rating agencies—not too difficult, inasmuch as they are currently not overseen at all. Under present regulation, the SEC grants to select applicants the status of Nationally Recognized Statistical Rating Organization (NRSRO) based as much—if not more—on such entities being nationally recognized (and, prior to the present crisis, held in high repute) than on any other qualifying process. Our leading NRSROs—Standard & Poor's, Moody's and Fitch—are effectively granted the right to pass judgment on virtually all traded debt obligations and derivatives thereof (in the United States and, to a lesser extent, elsewhere), for which they are paid fees by the issuers of such debt. As most anyone who has been paying attention to the causes of the financial crisis is aware, the rating agencies ended up favoring their fees over their franchise reputations and blessed as highly creditworthy all manner of what proved to be garbage securities.

Both the Senate and House bills contain a number of prescriptions to regulate NRSROs' qualifications and business models. The general tenor of the bills' requirements is laudable. Nevertheless, there is no grand solution to the conflicts inherent in the rating agencies' current *modus operandi* because no one in Congress can advance an alternative. To be fair, there is also no politically viable alternative that jumps to mind. Eliminating the need for ratings by holders of securities that are themselves regulated financial institutions (banks, insurance companies, etc.) places our entire system of what are known as "risk based capital requirements" at risk. Financial institutions here (and abroad, per the Basel Accords) are chiefly regulated by requiring certain amounts of capital to be held relative to the assets' level of risk. And the principal determinant of most institutional assets' level of risk is, not surprisingly, credit ratings. So, to avoid having to chuck the entire underpinning of risk-based capital requirements, the reform legislation introduces the concept of increasing oversight and speaks out against the NRSROs' conflicts of interest. What this means is presently unclear. It could range from nationalizing the credit rating agencies (or allocating rating business to them via a lottery system, as has been discussed, to avoid the practice of "ratings shopping" by issuers) to requiring them to undergo the equivalent of a licensing process and hoping they're not "RWI" (rating while intoxicated) in the future by their greed for fees. The approach ultimately pursued could be a major factor in preventing another credit crisis—or not.

While they have been widely touted in both bills, we have intentionally not discussed the proposed new consumer financial protection agency and the Feds' and FDIC's resolution authority over substantially beefed-up failed financial institutions.

Consumer protection is a legitimate form of governmental regulation that sticks in the craw of any number of so-called conservative libertarian legislators ("so-called" because such folks have an unfortunate history of legislating in a manner that is neither fiscally conservative nor socially libertarian) and is therefore probably a good thing. But in and of itself, preventing high credit card fees and protecting borrowers from being seduced by silly television ads for unsound loans will do little to avoid recurring credit crises.

As for more robust resolution authority and the limits placed on bailing out financial institutions (and their shareholders/bondholders) in the future, this begs the question of whether the reform legislation, and resulting regulations, will be sufficiently strong to massively limit the prospective need for the resolution or bailout of systemically critical institutions to begin with. As we have seen, no law limiting bailouts will prevent emergency legislation to the contrary if it means that, one day in the future, all the ATMs and credit lines are otherwise going to run dry—the prevention of which will always be the ultimate form of *realpolitik.*

Conclusion

The only practical way to avoid another disaster is to promulgate real limits on the more risky operations and activities of systemically critical financial institutions. The essence of all law governing our commercial interaction rests on limitations—beginning with "thou shall not steal" all the way up to the complexities of banking, securities and exchange regulations. While this Congress can apparently only outline its intentions in the reform bill, only after it is signed into law by the president, the impact on the financial industry—and the extent to which it protects taxpayers—will not be clear until we see how it's interpreted by regulators. One can hope the latter group is sufficiently chastised by recent history to act forcefully where Congress has been unable to do so, and that even a strongly interpreted regulatory implementation of the pending law remains on the books and isn't reinterpreted in a resurgence of deregulatory fervor.

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