

Douglas J. Elliott
The Brookings Institution
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Financial Reform: Now It's Up to the Regulators

The simpler half of financial reform will be completed shortly with the passage of the Dodd-Frank financial reform bill and its receipt of the president's signature. Hard as it may be to conceive, the complexity embedded in its over 2000 pages of text is likely to be exceeded by the complications inherent in the regulatory implementation of financial reform. Nor is this just a technical question of working through the multiple thousands of pages of rule-writing, the creation of operating procedures, and the writing of supervisory guidelines. Critical choices will be made -- regulatory decisions are likely to be as important as the law itself in determining the success or failure of the effort to bring needed stability to our financial system.

This paper will address the following questions:

- What will be the key decisions for regulators to make?
- Why will regulatory decisions matter?
- Who are the regulatory bodies?
- Why is global coordination critical?

What will be the key decisions for regulators to make?

There are many varied factors that caused the financial meltdown that thrust us into the recent terrible recession. Therefore the Dodd-Frank bill and associated regulation are attempting to tackle a very broad set of issues. Some of the key areas requiring regulatory decisions are:

Consumer protection. Dodd-Frank establishes a new Consumer Financial Protection Bureau (CFPB). Regulators will decide almost everything about how this works. Congress laid out a broad mandate, a set of criteria to be considered when balancing decisions, and a few limitations. The rest will be up to the regulators, since the CFPB will be empowered to consider a wide range of matters, setting its own priorities as to what to tackle first. These initial structural and substantive decisions will matter considerably, since precedents, once established, create very substantial political and bureaucratic inertia. Regulators find it easier to write on a blank slate. In contrast, changing earlier decisions entails career and political risks.

Derivatives. Congress directed the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) to take a number of crucial steps to reduce the risk of the derivatives markets and to make them more transparent. In particular, they are to ensure that standardized derivatives are traded on exchanges and cleared through central clearinghouses and that

appropriate collateral and capital requirements are set for those derivatives that continue to be traded over the counter (OTC). Banking regulators will also be heavily involved, since the major derivatives dealers are all affiliated with commercial banks at this point.

Congress, appropriately, left a great deal to be decided by the regulators in this area. They will need to determine the rules for when a derivative is considered standardized enough that it must be traded on an exchange and/or cleared through a central clearinghouse. Indeed they may even be called on to make decisions on specific derivatives at times, especially until the rules are clear to everyone. They will also need to set the rules determining the collateral that derivatives counterparties must put up on over the counter (OTC) trade, as well as the capital required by banks and their affiliates on those trades. These choices will significantly affect the cost and attractiveness of derivatives, which matters a great deal given the importance of these instruments in our financial system.

Beyond that, the law will make derivatives clearinghouses far more critical than they have been, which also means that careful attention will have to be paid to regulation of those clearinghouses. (In practice, these will be institutions that are “Too Big to Fail”, increasing the priority of careful regulation, since the taxpayer could be on the hook in an emergency.) There has been talk, for example, that the major derivatives dealers could be required to give up ownership or governance rights in derivatives clearinghouses, since they may have an incentive to make it harder for those entities to compete with OTC activities.

There may also be significant decisions to be made about how to implement the provisions backed by Senator Lincoln that force certain types of derivatives transactions out of commercial banks and into their affiliates, if they are still to be done within the banking group.

Securitization and rating agencies. Congress mandated a number of changes to securitizations and to how the rating agencies that are central to that market must operate. In some cases these changes were more specific than in some of the other parts of the bill, but there remain a considerable number of decisions that are left up to the regulators. For example, the SEC is mandated to study whether there is a better approach than Senator Frankel’s provision that has the federal government determine who the first rating agency is for any new securitization. (Others could be hired as well, but this would guarantee that a rating would be available from at least one agency not chosen by the issuer or their investment bank.) If no better method is found, then Senator Franken’s provision will take effect. There will also doubtless be questions about how to implement the “skin in the game” requirement that issuers of securitizations keep 5% of the risk and hold it unhedged, with a number of exceptions for safer and more standardized mortgage backed securities where the 5% requirement is waived.

The Volcker Rule. Congress ordered the banks, after a transition period, to shed their proprietary activities. This rule is intended to prevent commercial banks and certain affiliates from engaging in some types of speculative trading and investment that are considered to be “proprietary”. However, there is no satisfactory definition of what this means. Nor are there clear definitions of the several exemptions to the proprietary trading rules, such as the maintenance of securities inventories to facilitate customer

transactions. The regulators will be faced with the need to find a way to operationalize the limitations they are required to impose. If they err on the side of toughness, it may limit legitimate bank activities and increase customer costs, whereas if they err in the other direction it could effectively gut what Congress intended.

Oversight of the financial system as a whole. There is broad agreement that one of the failings of the prior regulatory system was that no one was clearly responsible for monitoring the system as a whole, such as watching out for developing bubbles in the housing market or elsewhere. Congress therefore established the Financial Stability Oversight Council, which is to delegate much of its efforts to the Fed. This council is new, as is the Fed's role in working as its agent. As with the CFPB, this means that regulators will be making critical decisions about how it will all work, as they build the structure.

"Too Big to Fail". The media, public, and politicians have devoted a great deal of attention to the question of how to deal with systemically important financial institutions, ones where the government might be forced to intervene if they ran into trouble in a future financial crisis. Although some members of Congress pushed hard for specific limits on the size and activities of these institutions, virtually all of the restrictions in Dodd-Frank are based on regulatory discretion. The Financial Stability Oversight Council has the discretion to determine that any financial institution is systemically important. Under those circumstances, the council acquires a great deal of discretionary authority to force divestiture of certain activities, the raising of additional capital, or other steps, as the regulators deem necessary. In addition, it is likely that additional burdens will be placed on the big banks and other systemically important institutions, such as the imposition of higher capital requirements than those existing for smaller banks. It is already clear that any additional taxes or insurance premiums on banks will be tilted to make the larger institutions pay higher percentages.

Why will regulatory decisions matter?

There are multiple reasons why regulatory decisions will be so important:

Congress often specifically ordered the regulators to decide how to handle an important issue. There are at least 40 instances in the legislation where Congress required the Fed, the SEC, or another regulatory body to conduct a formal study and then choose how to address a specific issue. For example, the SEC is ordered to study whether securities dealers should be subject to fiduciary legal obligations when they market products to retail customers. The Fed is also instructed to determine appropriate limits on interchange fees for debit cards, which will presumably entail a formal study since it will be a new activity for regulators.

New legislative mandates will require a large number of critical implementation decisions. There are a number of new aspects of regulation that are created under Dodd-Frank which will require regulators to make key policy decisions that will set precedents for many years to come. The most obvious is the creation of the Consumer Financial Protection Board, which will be a largely independent body that is technically part of the Fed. The CFPB is mandated to protect consumers while maintaining a proper

balance between that protection and the ability of financial institutions to provide customer services effectively and efficiently. As noted earlier, future Boards are likely to be influenced considerably by the choices made in the first years of its existence, if only because it is more dangerous, politically and bureaucratically, to change a past precedent than to make an entirely new ruling.

Another important new area with considerable regulatory discretion is the implementation of the Volcker Rule, as described earlier.

The need for global harmonization of financial reform adds complexity and increases the importance of regulatory choices. The most critical examples of this come in the areas of minimum capital and liquidity requirements. The legislation encourages the regulators to raise these requirements significantly, but leaves up to them how high the requirements should go and how the tests should be calculated. There is already an international coordinating process for these two crucial areas, known as Basel III, run by the Basel Committee on Banking Supervision. The final international agreement will have a major effect on the financial sector and, potentially, on the economy as a whole. The Institute of International Finance (IIF), an industry group, has preliminarily calculated that the economies of the US and Europe could be 3% smaller after five years than they would be without the Basel III rules. My own analyses¹ suggest this figure is quite considerably overstated, but there clearly will be a significant impact which will almost certainly take the form of a trade-off of reduced economic growth in most years in exchange for the mitigation of damage to the economy during financial crises.

Many policy decisions must be made by experts in order to have a chance of being effective, given the complexity of the financial sector. Congress is sometimes accused of micro-management, but the complexity of the financial sector and the vast scope of the reforms would have defeated any effort by Congress to make all the important decisions. For example, Congress largely left changes in the regulation of bank compensation practices up to the regulators themselves, an authority that already existed under their general powers to set safety and soundness regulation. The Fed has issued preliminary guidance in this area, and may follow with greater specificity. Changes to derivatives rules are another example of an area too complex for Congress to make all the key decisions.

Day-to-day supervisory decisions will matter. Supervision of banks and other financial institutions will become an even harder and more complex task as the new legislation creates a more hands-on role for regulators. There will be a multitude of decisions that will be affected by how regulators lean in making choices and in providing guidance to the institutions they supervise. For example, it has been alleged that supervisors have been too tough in the aftermath of the financial crisis in their judgments about the riskiness of bank loans and that this excessive conservatism has harmed the economic recovery by stifling lending. Such systematic biases might well arise in various areas under the new regulatory paradigm.

¹ See http://www.brookings.edu/papers/2009/0924_capital_elliott.aspx and http://www.brookings.edu/~media/Files/rc/papers/2010/0129_capital_elliott/0129_capital_requirements_elliott.pdf

Influencing day-to-day decisions by thousands of bank examiners is not going to be easy even for the heads of the supervisory agencies. For example, it seems fairly clear that Fed Chairman Bernanke and other top regulators were sincere in urging their employees not to be excessively conservative in evaluating bank loans. However, the bank examiners in the trenches also knew that they were operating in an environment in which the short-term damage to their career from being lenient was potentially much worse than any kudos they might receive for indirectly encouraging economic growth by being as balanced as possible. (A bank insolvency could hurt their careers, while they might receive no credit for avoiding excessive conservatism.) Nonetheless, over time, and with the right incentive structures, top regulators can have a significant influence on how their underlings operate.

Who are the regulatory bodies?

There is a wide array of regulatory and quasi-regulatory bodies that will have an important influence on the success of financial reform. These include the following. (For simplicity, I have left off insurance regulatory bodies, since they will play a lesser role in implementing financial reform. However, they could prove to be important over time if there is a shift of financial business into insurance entities.)

U.S. entities

- The Federal Reserve Board (in Washington)
- The Federal Reserve Bank of New York (which has the lead in dealing with markets)
- The Office of the Comptroller of the Currency
- The Federal Deposit Insurance Corporation
- The Consumer Financial Protection Bureau
- The Financial Stability Oversight Council
- The Treasury Department
- The Securities and Exchange Commission
- The Commodities Futures Trading Commission
- The state bank regulators
- Financial Industry Regulatory Authority (FINRA)
- The various financial exchanges, which exercise some self-regulation
- The Financial Accounting Standards Board

Multi-lateral entities

- The Basel Committee on Banking Supervision
- The Financial Stability Board
- The Committee on the Global Financial System
- International Organization of Securities Commissioners (IOSCO)
- The International Monetary Fund, which has been given technical tasks by the G-20
- The International Accounting Standards Board

Key Europe-wide entities

- The European Central Bank
- The committee of European bank regulators that is being established under pending legislation
- The committee of European securities regulators that is also being established
- The European Systemic Risk Council that is also being established

Other international entities

- Central banks around the world
- Other banking supervisors around the world
- Other securities regulators around the world

Why is global coordination critical?

Global coordination of public policy in any complex area is difficult, time-consuming, and requires the U.S. to compromise on some of our preferred approaches. Why then should the U.S. regulators put a major effort into global coordination of financial reform? There are at least four reasons why we should often compromise in order to ensure global standards that meet acceptable minimums:

Regulatory arbitrage can create a dangerous race to lower standards. A large portion of the business of finance is truly global and virtually all of the rest is affected indirectly by global competition. If one jurisdiction chooses to set rules that are too lenient in significant ways, there would be a strong tendency for finance business to move there. It is true that sound regulation is in almost everyone's long-term interest because of the damage to the financial industry and the economy that is caused by financial crises. However, business can be substantially cheaper to do during the non-crisis years if regulation is lax. For example, capital is expensive and the direct benefits of holding more capital are negligible during good times, so financial institutions are tempted to skimp on this form of protection if regulators will allow them to do so. The temptations for regulators to become lax and for financial institutions to take advantage of this grow with every year that passes since the last major financial crisis. (The unusually long period of "good times" in the financial markets was a major contributor to the severity of the financial crisis we just went through².)

Much of the effort of the Basel Committee on Banking Supervision over recent decades has focused on harmonizing capital requirements globally. This is a natural area for regulatory arbitrage, since capital is expensive and banks can easily measure the effects of requirements in different jurisdictions. A major driver of the institution of the first capital rules set by the Basel Committee (Basel I, as it is now known) was a belief by the U.S. and U.K. banks and their regulators that the Japanese were allowing excessively low capital levels at their banks in order to promote international competitiveness.

² Please see http://www.brookings.edu/papers/2009/1123_narrative_elliott_baily.aspx by Martin Baily and me.

The competitiveness of U.S. financial institutions is affected by international rules. The financial sector is a major part of the U.S. economy. Financial activities constitute over a tenth of GDP, our financial institutions employ millions of people, and the leading global position of many of these institutions makes them a significant exporter in an American economy that could use more exports. If international rules are laxer than American ones, then our institutions are likely to lose business in addition to operating in a global financial environment that would be riskier because of foreign failings.

So far this discussion has emphasized the need for uniformly rigorous standards, but global financial competition also puts pressure on U.S. regulators not to impose excessively burdensome rules. If we set requirements that buy little or no safety at the cost of significant inefficiencies, other countries are unlikely to follow. In that case, we would be handicapping our own institutions for no good reason. The trick, of course, is to figure out when a costly regulation is necessary rather than unduly burdensome.

Financial crises have a habit of spreading around the world. Even if we could avoid or live with the loss of international competitiveness resulting from lax regulation elsewhere, we have learned again recently that financial crises do not respect international borders. This is partly due to direct financial ties between institutions in different countries, partly due to international capital flows set off by crises, and partly due to changes in sentiment that can spread around the world, including the onset of outright panic. It is in our interest to encourage other nations to avoid lax regulation that could trigger such crises.

Economic pain in other countries affects us as well. In the unlikely event that we could protect our own financial institutions and markets from all the direct effects of a financial crisis elsewhere, we would still suffer through trade flows and currency movements. Major financial crises generally create or exacerbate recessions or substantial declines in economic growth, as we saw very clearly two years ago. More recently, the Euro-crisis that started this spring is likely to affect American exports, both to European countries and to nations where we compete with European exporters. America is less vulnerable to these effects because our export sector is smaller than in many countries, but the effects will still be noticed.

In sum, we will often be better off with globally harmonized rules that ensure acceptable regulatory standards and approaches in the major financial centers even when that means that the rules are not entirely to our liking. This does not mean that every globally harmonized agreement is to our advantage. There is a lively debate going on now as to whether we would have been better off if we had applied the second set of Basel capital rules (Basel II) to our commercial banks in advance of the recent crisis, rather than dragging our feet on implementation. Those who believe it would have directly harmed our financial system may not be convinced that the global benefits would have outweighed our costs, or perhaps even the costs to the rest of the world.

Conclusions

Regulators here and around the world will be critical to the success of financial reform. It behooves us to pay careful attention and to encourage decisions that appropriately balance increased safety with the regulatory burden imposed by new rules. Equally importantly, global harmonization will matter a great deal and should be encouraged, difficult and frustrating though the process can often be.

The greatest opportunities in this area stem from the expertise and dedication of financial regulators. The greatest dangers come from the complexity of financial markets, which means mistakes are easy to make, and from the lack of attention paid by the media, the public, and even Congress to the regulatory processes. Bureaucratic self-interest, ignorance of financial concepts, and excessively close ties to vested interests have more room to do damage when external attention is absent.