Bank Financial Group

Observation

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HIGHLIGHTS

- **The House of Representatives passed the Wall Street Reform and Consumer Protection Act on June 30, 2010. The Senate will likely vote on the bill within the next few weeks.**
- **The bill sets up several new regulatory bodies including the Consumer Financial Protection Bureau to write and enforce consumer protection regulations, and the Financial Stability Oversight Council, tasked with monitoring and reducing systemic financial risk.**
- **In an effort to avoid too-big-to-fail bailouts, the legislation creates a resolution mechanism for non-bank financial institutions through the FDIC.**
- **The bill will require financial institutions to keep some skin in the game when securitizing assets and provide greater oversight of credit rating agencies.**
- **Regulatory reform is a balancing act between promoting financial stability and maintaining the productive flow of credit. It is yet to be determined if this legislation gets the balance right. The bill leaves much in the hands of future regulators. Importantly, capital and leverage requirements will continue to be coordinated on a global basis through the Basel III framework.**

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U.S. FINANCIAL REGULATORY REFORM & THE DODD-FRANK BILL

In the wake of one of the worst financial crisis of the modern era, policymakers around the world have been focused on reducing the risk of future financial crises. In this vein, the House of Representatives has recently passed the Wall Street Reform and Consumer Protection Act (known as the Dodd-Frank Act), which will soon come to a vote in the Senate. The Dodd-Frank bill marks the first major volley in the ongoing process of U.S. financial regulatory reform. In order to win enough support in the Senate, there may be some minor changes to come, but the main framework of the legislation appears to be established.

The bill is large (over 2,300 pages) and broad, touching upon everything from consumer protection to regulation of credit rating agencies. It will take several years for many of the provisions in the bill to be implemented, and the specifics in terms of capital and liquidity requirements will be decided by regulators at a future date – the November G20 meeting in Seoul is tasked with reviewing Basel III proposals and nailing down the specifics in these crucial areas. Nonetheless, in terms of the basic framework for reform, the bill adds a fair amount of detail. The main components of the bill are outlined below:

Consumer Protection:

- Creates the Consumer Financial Protection Bureau (CFPB) that is led by an independent director located within the Federal Reserve. The new agency will be responsible for writing rules for bank and non-bank financial institutions. The CFPB will also be charged with enforcing regulations on banks with greater than $10 billion in assets, as well as all mortgage related businesses, pay-day lenders, student lenders and other large non-bank financial companies.
- Creates a new Office of Financial Education to consolidate efforts to increase financial literacy and acumen among the public.
- Enhances consumer protection by also including reforms to mortgage rules that will require mortgage lenders to ensure that a borrower is able to repay a home loan by verifying the borrower's income, credit history and job status. Payments to brokers for steering borrowers to high-priced loans are also prohibited.

Financial Stability and "Too-Big-to-Fail":

- Creates the Financial Stability Oversight Council (FSOC), chaired by the Treasury Secretary with representation among most major financial regulatory bodies. The council will be specifically tasked with monitoring systemic financial risks and making recommendations to the Federal Reserve towards tightening regulation on those financial institutions who, by nature of their size, are deemed to pose an increased risk to financial stability.
- With a 2/3 majority vote, the council has the power to authorize non-bank financial institutions to be regulated by the Federal Reserve. Moreover, if the Federal Reserve decides that a firm has become so large as to pose a signifi-

cant risk to financial stability, the council can approve, again with a 2/3 majority vote, a decision by the Fed to break the up the firm or divest some of its holdings. This power is separate from the resolution process (described below).

- Sets up a resolution process for insolvent non-bank financial institutions through the Federal Deposit and Loan Corporation (FDIC). (A process is already in place for the FDIC to unwind banks). In this process, the FDIC will take control of the non-bank financial institution and sell-off viable assets. Public funds will be used initially to cover the cost of unwinding the institution, but any remaining losses will be recouped by an ex-post fee imposed on large financial firms with more than $50 billion in assets.
- The legislation will also require large financial companies to submit contingency plans for their orderly shut down if insolvency was to occur. So called "funeral plans" are intended to aid regulators in understanding the structure of the company and aid in its resolution in the event of insolvency.

Derivatives:

- Over-the-counter (OTC) derivatives will be regulated by the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC). In the past, OTC derivatives had largely escaped regulatory oversight.
- Standard derivatives are to be cleared through centralized clearing houses and traded on exchanges. Regulators will determine which contracts qualify.
- Non-standard or customized derivatives may still be traded over-the-counter, but with increased transparency and data collection through swaps repositories.
- Banks can retain operations for interest-rate swaps, foreign-exchange swaps, and gold and silver swaps, but will be required to push trading in agriculture swaps, uncleared commodity swaps, most metals swaps, and energy swaps into separately capitalized affiliates.

Volcker rule:

- Banks will be restricted from proprietary trading on their own books. Nonetheless, banks can invest up to 3% of Tier-1 capital in hedge funds and/or private equity and provide up to 3% of the firm's equity.

Securitization:

- Requires banks that package loans into securitized assets to keep 5% of the credit risk on their balance sheet. Bank regulators can exempt low-risk mortgages from this requirement if they meet certain minimum standards. Regulators can also permit alternative arrangements for risk-retention for the commercial mortgage-backed securities market.

Hedge Funds:

- Hedge funds must register with the SEC as investment advisers and provide information on trades to help regulators monitor systemic risk.

Federal Reserve:

- Increased Federal Reserve oversight, including a one-time audit of the Fed's emergency lending programs during the financial crisis.
- Going forward, the Federal Reserve will disclose, with a two-year lag, details of loans it makes to banks through its discount window as well as open market transactions.
- The Federal Reserve's emergency lending authority will be restricted with the requirement that it be used to provide liquidity to a broad number of market players. The Fed cannot lend just to one institution singularly.
- The Secretary of the Treasury must approve lending programs and loans cannot be made to insolvent firms.

Credit Rating Agencies:

- An Office of Credit Ratings within the SEC will have the authority to fine ratings agencies. SEC may deregister an agency that is deemed to have given too many incorrect ratings over time.

Insurance:

- A new Federal Insurance Office will be created within the Treasury Department to monitor the insurance industry. The new office will be required to report to Congress on ways to modernize insurance regulation.

Capital and liquidity:

- The definition of Tier 1 capital, which forms the basis of protection against unexpected asset losses will be made more narrow to exclude trust-preferred securities that have both debt and capital characteristics.
- For banks with less than $15 billion in assets, current trust-preferred securities can continue to be considered

Tier 1 (but any new issuance would be excluded). For larger banks, a five-year phase-out period will be given to move to the new definition.

Comments and conclusions

Financial regulatory reform is a careful balancing act. It should be judged on how well it reduces risk in the financial system, while ensuring that financial institutions are still able to take prudent and appropriate risks that allow healthy flows of credit to businesses and households. The proposed legislation tackles a number of the U.S. financial system vulnerabilities that were exposed during the credit crunch. There is a greater degree of consumer protection and effort toward consumer financial education. It is evident that during the housing boom credit became too available (as evidenced by the ballooning of subprime loans), and many individuals took on financial commitments that they did not understand. Some financial market participants may have been comfortable with making low-quality loans because these loans would be securitized and the risk transferred to investors. In turn, investors were lulled into a false sense of security by the pristine credit ratings attached to these securities by bond rating agencies. The proposed legislation will require financial institutions to keep some skin in the game when securitizing and also provide greater oversight of credit rating agencies. Greater transparency is also being provided in derivative markets. Higher capital ratios and lower leverage ratios will be imposed, and this inherently improves the ability of firms to weather financial shocks. Greater oversight is being imposed on the financial system and there is recognition that risks can be systemic in nature – in other words regulatory oversight of individual institutions may miss some of the key risks to the system as a whole.

So, there is no question that the proposed legislation reduces risk, but does it strike the right balance between risk and credit flow? At this stage, it is too difficult to say. The proposed legislation may be long, but in many respects it is not clear as to how the reforms will be implemented. In addition, the details on capital and leverage ratio requirements have not been set. And it is not entirely clear how systemically important firms will be unwound in insolvency, as a great deal of discretion will be in the hands of regulators. Moreover, it is not evident how lenders will respond to the legislation. In the wake of the financial crisis, a key factor tempering the pace of economic recovery has been risk aversion amongst financial institutions that has curtailed the supply of credit to households and businesses. Aside from having to rebuild scarred balance sheets, the financial sector functions in a world plagued with uncertainty, on both domestic and global financial reform. At the margin, the clarification of financial sector reform provided in this bill may help reduce market uncertainty, but there are still too many loose ends that need to be tied. Finally, the bill does not address other key issues, including reforms to Fannie Mae and Freddie Mac. So, while the proposed changes provide a starting point, the finish line is still off in the distance.

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