

Financial Markets and Institutions

UPDATE: September, 2010

by

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FINANCIAL REFORM LEGISLATION

The Great Credit Crisis of 2007-2009 exposed many of the weaknesses of the regulatory structure of the U.S. financial system. In January, 2008 the newly elected President Obama convened his economic team and charged them with picking up on the measures begun by the Federal Reserve and the prior administration of President Bush to arrest the festering financial crisis. Their immediate task was to deal with the crisis and prevent a feared total collapse of the world financial system.

Subsequently, once the financial markets began to function more normally, attention was directed toward developing long-range plans that would ward off a reoccurrence of financial crises similar to the one that had just led to the longest and deepest economic recession in the United States since the Great Depression of the 1930s. The Obama Administration presented a proposal to Congress that was intended to achieve the following four major objectives:

- (1) Develop a system of oversight that would focus on potential threats to financial market stability before they developed.
- (2) Enhance consumer protection in financial market dealings.
- (3) Strengthen regulations on lightly or unregulated financial markets and institutions whose activities were seen to have contributed to the financial crisis.

(4) Achieve greater transparency in the actions of financial market participants and in financial contracts and accounting practices.

In July, 2010, Congress passed the Financial Reform Bill (known as the “Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010”) and it was signed into law by President Obama, ushering in the most sweeping changes to the regulations and oversight of the U.S. financial system in 70 years. Nearly every segment of the American financial markets and institutions will be affected. The goal of the bill was to provide a regulatory structure that would give regulators the authority needed to achieve the major policy objectives outlined above. The actual implementation of the legislation was left to the regulators themselves who will have to work out the details in the months and years to come.

The broad outlines of this historic legislation are listed below.

I. Create Consumer Financial Protection Bureau (CFPB)

- Independent director appointed by the President and confirmed by the Senate
- Housed in the Federal Reserve
- Examines and enforces consumer protection legislation over all large (assets > \$10B) financial and non-financial firms involved in consumer lending by consolidating regulatory oversight previously granted to:
 - Comptroller of the Currency (principal regulator of federally chartered banks)
 - Office of Thrift Supervision (now defunct, principal regulator of S&Ls)
 - Federal Deposit Insurance Corporation (FDIC)
 - Federal Reserve
 - National Credit Union Administration (principal regulator of Credit Unions)

- Federal Trade Commission (FTC, key agency involved in consumer fraud)

II. Create Financial Stability Oversight Council (FSOC)

- Chair: Treasury Secretary
- 9 members drawn from:
 - Federal Reserve
 - Security and Exchange Commission (SEC, principal regulator of the stock and bond markets)
 - Commodity Futures Trading Commission (CFTC, principal regulator of the futures and options markets)
 - Federal Deposit Insurance Corporation (FDIC)
 - Federal Housing Finance Agency (FHFA, recently created agency that oversees activities in the housing market, and is currently the government’s conservator over Fannie Mae and Freddie Mac)
- New Consumer Financial Protection Bureau
- Independent member who is knowledgeable of the insurance industry
- Monitor developments in the financial markets and identify any potential “systemic risk” problems that could produce instability in the financial system.
- Advisory Role: Make recommendations to the Federal Reserve for increasingly strict rules for suspect firms of: minimum capital requirements, provisions for adequate liquidity, and risk management
- Approve (with 2/3 vote) extending Federal Reserve regulations to non-bank financial firms if they pose a threat to financial stability (e.g., AIG)

III. "Too Big To Fail"

- Implement the FSOC's "Advisory Role" (above)
- "Volcker Rule": Prohibits banks from engaging in the following (investment banking) activities:
 - Proprietary "in-house" trading activities
 - Investing in "hedge funds"
 - Investing in "venture capital"
- Can extend the rules to non-bank financial firms that are seen to threaten the stability of the financial system
- "Funeral Plans"
 - Large, complex companies must submit plans for an orderly shut down of their operations, if they were to fail
 - Impose sanctions (higher capital requirements, etc.) on companies that do not present acceptable plans
- Liquidation Procedure
 - Must be agreed by Treasury, FDIC, and the Federal Reserve
 - Implemented by the FDIC
- Establishes an industry-based fund to absorb losses of liquidated firms
- Extends the Federal Reserve's role as "lender of last resort" to support financial firms during "destabilizing events" but not to prop up failing institutions

IV. Transparency and Accountability of Derivatives

- Regulation: SEC and CFTC will have authority to regulate trading activities in financial derivatives that are currently unregulated (such as CDOs and CDSs)
- Derivatives will be traded on organized exchanges and cleared at a centralized clearing house (such as the Chicago Board of Trade)

- Margin requirements will be imposed on uncleared trades
- Swap dealers and other market participants will be subject to capital requirements
- Transparency: Data collection and publication provided by the clearing houses for market participants and regulators.

V. Hedge Funds

- Must register with the SEC for the first time
- Must report trading activities and portfolio holdings to the SEC to be shared with regulators (FSOC) and Congress
- States are given the responsibility for regulating smaller hedge funds, but the size limit is raised from the current \$25 million in assets under management to \$100 million, which will substantially increase the workload for state regulators.

VI. Credit Rating Agencies

- Create the Office of Credit Ratings at the SEC to oversee activities of the sanctioned credit rating agencies (Nationally Recognized Statistical Ratings Organizations, NRSROs)
- Must report
 - Methodologies used in obtaining ratings
 - Use of 3rd party information in ratings
 - Track record for the ratings (how good they have been)
- Can be “deregistered” by the SEC for a poor ratings history
- Individuals allowed to take legal action against the ratings agencies if they can prove reckless conduct or willful misrepresentation in their ratings that led to financial losses for the individual
- Must require their ratings analysts to pass qualifying exams

VII. Securitization

- “Skin in the Game”: Originators of MBSs and other mortgage-related financial products must maintain a minimum of 5 percent credit risk in those financial instruments.
- Originators must provide greater disclosure of information needed to analyze the quality of the assets and their inherent risk.

VIII. Strengthen the Federal Reserve

- Federal Reserve will be the principal regulator over large, complex financial firms whose operations could pose a “systemic risk” to financial stability
- Creates a “Vice Chair for Supervision” on the Federal Reserve’s Board of Governors to be appointed by the President
 - Develop policy recommendations for supervision and regulation for the banks
 - Report to Congress semi-annually
- President of the Federal Reserve Bank of New York will be appointed by the President rather than by the Bank’s directors
- Government Accounting Office (GAO) can audit any emergency lending facility operated by the Federal Reserve

QUESTIONS

1. What were the objectives of the financial reform legislation as originally proposed by the Obama Administration? How was the legislation structured to meet each of these objectives?
2. The two most controversial aspects of the new legislation were: (i) the Volcker Rule and (ii) the establishment of the Consumer Financial Protection Bureau. Use the internet to determine the pros and cons of each.

3. Discuss the following statement: “It will be years before we fully understand the extent to which the new legislation will alter the financial markets and institutions, and therefore we will not know how successful it will be for some time.”
4. How will the changes affect the structure, regulatory responsibility, and oversight of the Federal Reserve System?
5. Some have argued that the hedge fund industry may be the most severely impacted by the new legislation. What aspects of the new legislation could make it more difficult for hedge funds to operate? What are the costs and benefits to the financial system as a whole?
6. One of the major issues that was debated in Congress was placing tax-payers at risk for firms that were deemed to be too big to fail. Explain how the new legislation is designed to forestall insolvency in large complex financial firms, and how tax-payers are to be insulated from and failures that do occur.
7. Credit-rating agencies were seen to have contributed to the financial crisis. How did they contribute? What is being done to limit a reoccurrence of their mistakes that had deepened the crisis?

Note to the Reader: Please note that the summary of the Financial Reform Legislation known as the Dodd-Frank Act of 2010 that we have described above is continually subject to change. Multiple regulatory agencies are now working on various parts of the 2000-plus page law and whole new sets of regulatory rules are being crafted each month and this process of change may go on for years. Therefore, we urge readers to follow the news and stay abreast of the latest changes themselves, and recognize that the salient features of the legislation described above are likely to undergo an evolution as the regulators gear up for their implementation.

SUGGESTED READINGS

A Senate banking committee summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 can be found at:

http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf

Testimony on September 30, 2010 by Federal Reserve Chairman Ben Bernanke before the Senate Committee on Banking, Housing, and Urban Affairs can be found at:

<http://federalreserve.gov/newsevents/testimony/bernanke20100930a.htm>

A Washington Post article that gives a hint as to the magnitude of the task of implementing the Dodd-Frank Act can be found at:

http://www.washingtonpost.com/wp-dyn/content/article/2010/07/15/AR2010071500464_2.html?sid=ST2010071504699