

Overhauling the System

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United States proposes most radical reform of financial regulation since the New Deal

THE global financial crisis has had a devastating impact on major financial markets, undermining the solvency of firms, disrupting trading liquidity, and forcing a rethinking of prudential regulation. The crisis has made these markets candidates for radical regulatory change. Whereas the regulatory focus had been on the soundness of individual banks, the crisis has shown the need to deal with the financial system as a whole, and such a systemic approach requires the proper regulation of the markets and of the transactions that reflect the interconnections between banks and other financial firms.

The change in approach is reflected in proposed regulatory standards from the Financial Stability Board, the International Organization of Securities Commissions, and such private organizations as the Group of 30 and the Institute of International Finance. Recent proposals from the U.S. Treasury Department reflect similarly fundamental changes in the approach to financial market regulations. The proposals must still be

drafted into legislation and approved by the U.S. Congress. But if legislators make few major changes, the Treasury proposals would become the first major overhaul of the U.S. financial system since the New Deal policies during the administration of President Franklin D. Roosevelt, when the world also faced a monumental economic crisis.

New Deal reforms

Over a seven-year period, starting in 1933, the United States reshaped the regulation of the market structures for banking, securities, derivatives, and mortgage and asset management (see box). New laws transformed the U.S. financial system from one plagued by fraud and frequent crises to one that set the world standard for stability, efficiency, and the ability to raise capital.

The key pieces of legislation ranged across many issues and the various financial sectors, but they are best understood when collected into categories that reflect their basic insights into markets: systemic stability, regulatory reorganization, transparency, enhancing market integrity, and reducing conflicts of interest.

Systemic stability. The Glass-Steagall Act separated traditional commercial banking activities—essentially lending and deposit-taking—from those conducted by securities broker-dealers—such as underwriting, acting as a dealer (market making), and investing in corporate stocks and bonds. As a result, the exposures of banks to cyclical fluctuations that affect securities were reduced, leaving banks more likely to be able to lend during recessions and recovery stages of the cycle. Other legislation required that certain commodity futures be traded on regulated exchanges and subjected trading in these markets to speculative position limits. The higher standard for margin (that is, collateral) at futures exchanges resulted in counterparty and market risks being more prudentially

buffered against loss. The securities acts were also designed to reduce excess volatility and provide greater market stability.

Reorganization. The Securities and Exchange Commission (SEC) was created to regulate and oversee securities markets and the asset management industry; the Federal Deposit Insurance Corporation (FDIC) was created to insure bank deposits. Substantial changes were made to the governance of the Federal Reserve System, including the make-up of the Board of Governors and the Federal Open Market Committee (FOMC).

Transparency. Corporations issuing securities in public markets were required to disclose the financial condition of their enterprises, and this was also applied to secondary market trading and to investment companies.

Market integrity. Fraud and manipulation in banking, securities, and derivatives markets were prohibited, which strengthened the hands of investors and regulatory authorities.

Conflicts of interest. These laws addressed many conflicts of interest in corporate governance and other investor areas such as asset management, especially mutual funds management. The Glass-Steagall Act also had the effect of preventing

banks, which have non-public information about corporate borrowers, from trading for their own accounts in corporate securities markets.

The system breaks down

The financial stability spawned by the New Deal began to weaken in the 1980s as deregulatory measures and innovations created gaps that left many financial firms and activities outside or inadequately covered by the regulatory framework. The securitization process took off in the 1980s and many banks shifted their main business focus from traditional lending to issuing and trading securities and derivatives. And there were excesses and misuses of securitized products and derivatives. The meteoric rise of over-the-counter (OTC) derivatives markets generated enormous trading income, while shifting risks off balance sheets. That had the effect of reducing both capital requirements and other prudential constraints on risk taking. The expansive use of special purpose entities distorted the interpretation of a bank's risk profile by allowing the institutions to keep some debts and risk exposures out of their consolidated financial statements.

The U.S. Treasury response

The U.S. Treasury Department recently released a reform proposal aimed at addressing a wide array of problems in the regulatory treatment of financial firms and markets that have become apparent during the financial crisis. Included in the proposal is a call for international cooperation to raise global standards for financial regulation and supervision. The proposal reflects the profound changes in the approach to regulation that have resulted from the financial crisis—retreating from the deregulation that began a quarter-century ago and instead harkening back to New Deal reforms. The new proposals can be understood along similar thematic lines.

Systemic measures and prudential regulation. The proposed measures include improved capital standards and liquidity requirements for all regulated financial firms. This includes measures to address off-balance-sheet items such as derivatives and lines of credit, and unconsolidated items such as special purpose entities. New requirements for provisioning for credit losses and accounting methodologies are intended to avoid procyclicality—when financial behavior magnifies the direction that the economy is already taking. The proposals also seek to reduce incentives for excess risk taking by linking executive compensation to long-term performance.

The Federal Reserve's general authority would be expanded to include systemically important financial firms (called Tier 1 financial holding companies), based on size or interconnectedness. The Fed's bank holding company oversight would be expanded to include owners of all federally insured depository firms—including previously exempt unitary thrifts and industrial loan banks.

The Treasury is seeking comprehensive regulation of OTC derivatives markets, comparable to the regulatory treatment accorded other financial markets. It seeks to move standard OTC derivatives onto regulated exchanges. It would require all OTC derivatives trades to be cleared through a clearinghouse

Key New Deal financial regulatory laws

1933 – **Glass-Steagall Act** separated commercial from investment banking activities. Created the deposit insurance program and allowed greater branching by national banks.

1933 – **Securities Act** established disclosure requirements for issuing securities (stocks or bonds) on public securities markets and established prohibitions against securities fraud and manipulation.

1934 – **Securities Exchange Act** created the Securities and Exchange Commission and authorized it for rule making and enforcement. The Act extended federal regulation to secondary market trading in securities. It also established a system for self-regulation.

1935 – (**Omnibus**) **Banking Act** reformed governance of the Federal Reserve and broadened its powers. It established the modern version of the Board of Governors and the FOMC, and it expanded their authorities. It set collateralization rates (known as “haircuts”) and terms for emergency lending by reserve banks.

1936 – **Commodity Exchange Act** increased federal prohibitions against fraud and expanded them to manipulation. It also required that futures brokers be registered and keep records. It authorized speculative position limits and prohibited the trading of options on certain agricultural products.

1940 – **Investment Company Act** regulated companies that primarily invest in other companies such as mutual funds. It required registration and disclosure, including transactions between managers and any affiliate and set rules on corporate governance regarding executive management, board of directors, and trustees.

1940 – **Investment Advisers Act** required advisers to register, report, and keep records of their client relations. It also prohibited certain transactions and fee arrangements on the basis of conflict of interest.

(sometimes called central counterparty)—which would become the counterparty to both sides of each trade—instead of the current bilateral clearing arrangements. It would also require higher collateral standards, including the use of initial margin, for all OTC derivatives trades to reduce the systemic threat from the buildup of large counterparty exposures. The proposal's trade reporting requirements would also enhance the ability of regulators to conduct market surveillance and to detect and deter fraud and manipulation.

Reorganization. The plan would create a new Financial Services Oversight Council to formalize information sharing and policy coordination among key regulatory authorities and resolve disputes over jurisdiction. The council would include the heads of the major federal financial regulators and be chaired by the Treasury Secretary and staffed by the Treasury Department.

A new National Bank Supervisor would take over the duties of the Office of Thrift Supervision (thrifts will be rechartered as national banks) and the Office of Comptroller of the Currency, which now regulates national banks.

The plan also would create an independent Financial Services Protection Agency to protect retail customers and investors—including home mortgage borrowers—in the financial services marketplace. This would entail removing consumer protection authority from the Fed but not the SEC and Commodity Futures Trading Commission. A new National Office of Insurance, within the Department of Treasury, would coordinate the national insurance industry and its state-level regulation and supervision.

The Federal Reserve would regulate the systemically important (Tier 1) financial holding companies and their subsidiaries and affiliates at home and abroad. It would have expanded authority to supervise and regulate all affiliates of bank holding companies and impose consolidated prudential regulation of financial holding companies. It would also have oversight of all systemically important payments, clearing, and settlement systems. The clearinghouses, now supervised by their respective regulator, would have access to the Fedwire (which electronically transfers payments between financial institutions), the discount window, and other Federal Reserve services.

Price transparency. The efficiency advantages of system-wide price transparency have long been thwarted by the enormous OTC derivatives markets, where prices are not public. By requiring that all OTC derivatives transactions be reported to a registry (unless otherwise reported to a clearinghouse) transparency is enhanced.

New requirements for reporting prices and volumes in OTC derivatives trades would radically change the ability of regulators to conduct market surveillance by observing once-hidden open positions and trading activities and improving the price discovery process. Better price discovery will make the trading process more competitive because end-users (non-dealers) will gain more information about the entire market.

Disclosure. The 1933 and 1934 securities acts established requirements for disclosure of key financial information as a condition for issuing and trading corporate equity and debt securities. The National Housing Act of 1934 led to the creation of the conventional home mortgage contract, standard-

ized loan documentation, and a secondary market for home mortgages. In a similar vein, the Treasury plan calls for the SEC to develop standardized documentation for securitization and enhanced disclosure requirements for the issuance and trading of securitized debt instruments. The lack of transparency and inadequate due diligence were important factors in the failure of the market for structured mortgage securities. The proposed measures appear designed to make information about the securitization structure and the underlying assets more accessible to facilitate greater due diligence on the part of investors.

Market integrity. The plan calls for the managers of most hedge funds, private equity, venture capital, and other such private pools of capital to register with the SEC, and report and keep record of their activities. The level of reporting is designed to be sufficient to allow regulators to determine whether the investment pools have become so large, leveraged, or interconnected that they threaten systemic stability.

Registration would help reduce the incidence of embezzlement and other fraud by screening managers. The position reporting requirements would address concerns about market manipulation, turbulence due to short selling, and the distorting effect of hedge funds investments on commodity prices. These measures should also help make markets more trustworthy, improve investor confidence, and raise the surveillance capacity of supervisory authorities.

The Treasury plan also would reinstall anti-fraud and anti-manipulation prohibitions in OTC derivatives markets that were removed in a deregulation act in 2000.

Conflicts of interest. The Treasury proposes to address an array of conflicted investor relations. Issuers of asset-backed securities will be required to retain a portion of credit risk to exert market discipline on underwriting and risk transference. Executive compensation schemes will be required to shift focus from short-term gains to long-term performance. Credit rating agencies will be required to disclose their business relations with issuers, including fees they collect. Investment advisors managing hedge fund and other private capital pools will be restricted from certain other activities.

A new “New Deal”

The reform proposals represent a fundamental shift from the laissez-faire emphasis on self-governing financial firms that prevailed prior to the crisis to one in which prudential measures are used to improve the conduct of financial markets and govern the externalities that arise from large-scale risk taking. They appear to follow the same economic wisdom as those from the New Deal that reshaped the financial markets following the 1929 market crash and ensuing bank failures. The reforms of the 1930s produced a strong record of success. That is a daunting benchmark of comparison to this modern sequel, but the Treasury proposal has two advantages New Deal reformers did not: lessons of the New Deal experience itself and knowledge that the regulatory framework will need to anticipate future innovations. ■

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