

# DMACommentary

by David E. McClean, Ph.D.

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## The White House Releases Proposals for Overhaul of Financial Services Regulation

In January, my DMA Commentary dealt with the question of what regulators should do, given the credit crisis and related crises among financial services firms, and the way these crises impacted ordinary people, from New York to Shanghai. I also suggested that certain things could get done by summer, if the Obama team really wanted to reform the institutions and systems that allowed the crises to occur.

Well, while specific policies and regulations have not yet rolled out, it seems that the administration was indeed serious, and deserves credit for being careful and deliberative. The White House just released the administration's proposals in a white paper: *Financial Regulatory Reform: A New Foundation*.

In my January Commentary I recommended a number of specific changes, all of which are taken-up by the White House in the white paper. In particular, I recommended that a specific agency be created to monitor systemic risk – not just regulate to force compliance with existing rules (we have enough agencies doing that already). I also recommended that CDS market reforms not be limited to new derivatives exchanges, and that more stringent internal capital requirements be considered for the writers of protection. In addition, I recommended that hedge funds be regulated pursuant to a regulatory regime that was similar to the regime imposed by the SEC in its previous and ill-fated attempt to regulate these entities. I forwarded these ideas to both the White House and to Congressional leaders.

**Systemic Risk.** On the issue of systemic risk, having the Fed or an existing federal agency (or agency leaders) serve as “Risk Czar” (whether on a council or in some other form) would not be my preference. Why not start fresh – with a new entity/agency whose *sole* charge would be monitoring systemic risk? But the idea is what took and, I suppose, is what counts, and whether it's the Fed, or a council, or some new entity, the need for some agency with a mile high view of systemic risk is sorely needed.

**Hedge Funds and Pooled Investment Vehicles.** The regulation (re-regulation) of hedge funds was expected, and is also contained among the proposals, along with a call for greater transparency. What “transparency” will come to mean remains to be seen, however. The devil will be in the details. As pointed out in January, many hedge fund managers do not object to a regulatory regime that is based upon registration with the SEC and a manageable set of compliance obligations, but the types of transparency sought may prove to be the bugbear. The government would do well to address actual problems, and not invent issues around transparency that are beside the point.

**Derivatives.** Regarding derivatives, the administration was wise to include this among the proposals:

Key elements of that robust regulatory regime must include *conservative capital requirements* (more conservative than the existing bank regulatory capital requirements for OTC derivatives), business conduct standards, reporting requirements, and conservative requirements relating to initial margins on counterparty credit exposures. (Emphasis added.)

This is a bummer for the freewheeling derivatives markets, in which so much money was made by banks, dealers and other players. But the need for these reforms is now obvious, even to them.

Here is a summary of the specific recommendations. My analysis and further commentary will follow, later in the month and will be posted (along with this Commentary) at [www.dmaconsultinggroup.net](http://www.dmaconsultinggroup.net).

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## INTRODUCTION

Over the past two years we have faced the most severe financial crisis since the Great Depression. Americans across the nation are struggling with unemployment, failing businesses, falling home prices, and declining savings. These challenges have forced the government to take extraordinary measures to revive our financial system so that people can access loans to buy a car or home, pay for a child's education, or finance a business.

The roots of this crisis go back decades. Years without a serious economic recession bred complacency among financial intermediaries and investors. Financial challenges such as the near-failure of Long-Term Capital Management and the Asian Financial Crisis had minimal impact on economic growth in the U.S., which bred exaggerated expectations about the resilience of our financial markets and firms. Rising asset prices, particularly in housing, hid weak credit underwriting standards and masked the growing leverage throughout the system.

At some of our most sophisticated financial firms, risk management systems did not keep pace with the complexity of new financial products. The lack of transparency and standards in markets for securitized loans helped to weaken underwriting standards. Market discipline broke down as investors relied excessively on credit rating agencies. Compensation practices throughout the financial services industry rewarded short-term profits at the expense of long-term value.

Households saw significant increases in access to credit, but those gains were overshadowed by pervasive failures in consumer protection, leaving many Americans with obligations that they did not understand and could not afford. While this crisis had many causes, it is clear now that the government could have done more to prevent many of these problems from growing out of control and threatening the stability of our financial system. Gaps and weaknesses in the supervision and regulation of financial firms presented challenges to our government's ability to monitor, prevent, or address risks as they built up in the system. No regulator saw its job as protecting the economy and financial system as a whole. Existing approaches to bank holding company regulation focused on protecting the subsidiary bank, not on comprehensive regulation of the whole firm. Investment banks were permitted to opt for a different regime under a different regulator, and in doing so, escaped adequate constraints on leverage. Other firms, such as AIG, owned insured depositories, but escaped the strictures of serious holding company regulation because the depositories that they owned were technically not "banks" under relevant law.

We must act now to restore confidence in the integrity of our financial system. The lasting economic damage to ordinary families and businesses is a constant reminder of the urgent need to act to reform our

financial regulatory system and put our economy on track to a sustainable recovery. We must build a new foundation for financial regulation and supervision that is simpler and more effectively enforced, that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial market.

In the following pages, we propose reforms to meet five key objectives:

*(1) Promote robust supervision and regulation of financial firms.* Financial institutions that are critical to market functioning should be subject to strong oversight. No financial firm that poses a significant risk to the financial system should be unregulated or weakly regulated. We need clear accountability in financial oversight and supervision. We propose:

- A new Financial Services Oversight Council of financial regulators to identify emerging systemic risks and improve interagency cooperation.
- New authority for the Federal Reserve to supervise all firms that could pose a threat to financial stability, even those that do not own banks.
- Stronger capital and other prudential standards for all financial firms, and even higher standards for large, interconnected firms.
- A new National Bank Supervisor to supervise all federally chartered banks.
- Elimination of the federal thrift charter and other loopholes that allowed some depository institutions to avoid bank holding company regulation by the Federal Reserve.
- The registration of advisers of hedge funds and other private pools of capital with the SEC.

*(2) Establish comprehensive supervision of financial markets.* Our major financial markets must be strong enough to withstand both system-wide stress and the failure of one or more large institutions. We propose:

- Enhanced regulation of securitization markets, including new requirements for market transparency, stronger regulation of credit rating agencies, and a requirement that issuers and originators retain a financial interest in securitized loans.
- Comprehensive regulation of all over-the-counter derivatives.
- New authority for the Federal Reserve to oversee payment, clearing, and settlement systems.

*(3) Protect consumers and investors from financial abuse.* To rebuild trust in our markets, we need strong and consistent regulation and supervision of consumer financial services and investment markets. We should base this oversight not on speculation or abstract models, but on actual data about how people make financial decisions. We must promote transparency, simplicity, fairness, accountability, and access.

We propose:

- A new Consumer Financial Protection Agency to protect consumers across the financial sector from unfair, deceptive, and abusive practices.

- Stronger regulations to improve the transparency, fairness, and appropriateness of consumer and investor products and services.

- A level playing field and higher standards for providers of consumer financial products and services, whether or not they are part of a bank.

(4) *Provide the government with the tools it needs to manage financial crises.* We need to be sure that the government has the tools it needs to manage crises, if and when they arise, so that we are not left with untenable choices between bailouts and financial collapse. We propose:

- A new regime to resolve nonbank financial institutions whose failure could have serious systemic effects.

- Revisions to the Federal Reserve's emergency lending authority to improve accountability.

(5) *Raise international regulatory standards and improve international cooperation.* The challenges we face are not just American challenges, they are global challenges. So, as we work to set high regulatory standards here in the United States, we must ask the world to do the same. We propose:

- International reforms to support our efforts at home, including strengthening the capital framework; improving oversight of global financial markets; coordinating supervision of internationally active firms; and enhancing crisis management tools.

In addition to substantive reforms of the authorities and practices of regulation and supervision, the proposals contained in this report entail a significant restructuring of our regulatory system. We propose the creation of a Financial Services Oversight Council, chaired by Treasury and including the heads of the principal federal financial regulators as members. We also propose the creation of two new agencies. We propose the creation of the Consumer Financial Protection Agency, which will be an independent entity dedicated to consumer protection in credit, savings, and payments markets. We also propose the creation of the National Bank Supervisor, which will be a single agency with separate status in Treasury with responsibility for federally chartered depository institutions. To promote national coordination in the insurance sector, we propose the creation of an Office of National Insurance within Treasury. Under our proposal, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) would maintain their respective roles in the supervision and regulation of state chartered banks, and the National Credit Union Administration (NCUA) would maintain its authorities with regard to credit unions. The Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) would maintain their current responsibilities and authorities as market regulators, though we propose to harmonize the statutory and regulatory frameworks for futures and securities.

The proposals contained in this report do not represent the complete set of potentially desirable reforms in financial regulation. More can and should be done in the future. We focus here on what is essential: to address the causes of the current crisis, to create a more stable financial system that is fair for consumers, and to help prevent and contain potential crises in the future.

These proposals are the product of broad-ranging individual consultations with members of the President's Working Group on Financial Markets, Members of Congress, academics, consumer and investor advocates, community-based organizations, the business community, and industry and market participants.

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