
US financial reform linked to bank bail-out strategies

- Paul Volcker is coming into the Obama administration as an all-round counselor. But naturally, by virtue of his expertise and personal interests, he will be deeply involved in trying to fix the dysfunctional system of supervision and regulation of financial markets and institutions that now exists in the US and internationally.
- For some months, Volcker has chaired an informal working group on financial reform set up by the Group of Thirty, G30, a public-private consultative organization. The goal was to develop proposals for improving the global financial system “once the present crisis has passed.”
- The G30 report was published last week. Its recommendations are certain to form the core of the Obama administration’s effort to achieve “comprehensive financial reform so that the U.S. economy and the global economy never again face a crisis of this severity,” as Treasury Secretary-designate Tim Geithner put it during his Senate confirmation hearings Wednesday.
- However, many of the recommendations are bound to stir up intense resistance from numerous financial institutions, especially those not subject to strict supervision and regulation today. Volcker’s proposals will not go through unscathed unless members of Congress ignore institutions that make large campaign contributions and their lobbyists who defend the status quo.

A complex plan: What will pass easily and what will meet fierce resistance?

The G30 working group report was prepared under the close supervision of former Fed Chairman Volcker, along with his two co-chairmen, former Bank of Brazil Governor Arminio Fraga Neto and former Italian Minister of Economy and Finance Tommaso Padoa-Schioppa. It addresses major policy challenges in defining the public sector’s role in safeguarding financial stability, ensuring fair and effective competition in the financial markets, and developing international consistency and coordination. It also has a lot to say about improving corporate governance, accounting practices, and risk management within individual financial institutions.

There are detailed proposals in each of these areas, organized under what the G30 calls four “core recommendations.” They are as follows:

1. Gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated. All systematically significant financial institutions, re-

gardless of type, should be subject to appropriate prudential oversight.

2. The quality and effectiveness of prudential regulation and supervision must be improved.
3. Institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital, and liquidity.
4. Financial markets and products must be made more transparent, with better-aligned risk and prudential incentives. The infrastructure supporting such markets must be made much more robust and resistant to potential failures of even large financial institutions.

Plugging gaps: tougher than it looks

Many of the first few recommendations in the G30 report have been generating fierce fights for decades. Consolidated supervision of banks that take government insured deposits is relatively easy to swallow. Nobody disagrees that very large banks need more supervision than smaller ones. In fact, they already do, but the supervisors didn’t stop them from gambling with the taxpayers’ money. But in the US, state banking commissioners refuse to step aside to the Fed on the supervision of state-chartered banks. That will have to be compromised out.

Even more controversial, and certain to lead to a no-holds-barred battle if it makes it into the final Obama reform proposal, is that the biggest financial institutions shouldn’t be able to run hedge funds or private equity firms in-house. The main investment banks, now all either associated with commercial banks or converting into bank holding companies themselves, have been running these kinds of proprietary commingled pools of funds for many years. They will not take kindly to being pushed out of the business.

Just as nasty will be the likely fight with the money market funds, whose assets now total well over USD 3 trillion. Here is what the G30 proposes: “Money market mutual funds wishing to continue to offer bank-like services, such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value (NAV) at par, should be required to reorganize as special-purpose banks, with appropriate prudential regulation and supervision.” After the report became public, the industry immediately issued a strongly-worded statement that basically dismissed the proposal out of hand. No one in Washington was thrilled with having to support money funds with essentially deposit insurance facilities when a number of money funds were in danger of “breaking the buck” last fall. That

means they were not able to meet redemptions at USD 1 par. The Volcker group essentially put its collective foot down against this happening once the crisis is over. But the money funds are not going to accept all the regulatory burdens, and costs, of becoming special purpose banks.

But the biggest battle of them all will probably be with the hedge funds, among which one can find lots of Obama supporters. The G30 report comes out in favor of mandated registration of hedge funds. Remember that when the SEC tried to impose a simple registration requirement through a ruling three years ago, the hedge fund industry association took it to court – and the judge sided with the hedge funds. But the requirement could be inserted in legislation, which the Volcker group contemplates would go well beyond registration. Instead, it would give a prudential regulator (presumably the Fed or the SEC in the case of the US) the authority to demand periodic regulatory reports from the hedge funds, together with “public disclosures of appropriate information regarding the size, investment style, borrowing, and performance of the funds under management.” And for the biggest hedge funds, the regulator could impose capital, liquidity, and risk management standards. Because hedge funds tend to use offshore locations to house some of their accounts, the G30 report recognizes that an international agreement would be needed to impose regulatory jurisdiction where the funds actually do most of their business.

Some other G30 suggestions are much less inflammatory. The report comes out against non-banks owning and controlling banks, a separation that Volcker has been fighting for over the years, more or less successfully. Less contentious are its proposals regarding government-sponsored entities. Now that Fannie and Freddie are essentially back in public ownership – or very close to it – and a new regulatory framework has been imposed by Congress, the issue has basically gone away. But the G30 report is correct to point out that a mortgage business blending private and public control is unwieldy and undesirable, as events have proved.

Improving quality of regulation

In the wake of the meltdown of the financial markets and the excessive risk-taking, bordering on gambling, that has led to the demise or near failure of a number of world-famous institutions, it is not difficult to conclude that existing prudential regulation and supervisory oversight was inadequate to protect the public. The G30 report’s recommendations are all well-thought out and will not be opposed very strenuously by anybody, at least in Washington. Other countries may be less willing to go along.

These recommendations include eliminating “unnecessary overlaps” and gaps in coverage. They also include an appeal

to keep financial regulators sheltered from political interference (which in many cases may be easier said than done).

Because so many of the G30 current and former members have come from the world of central banking, it is not surprising that the report comes down in favor of central banks accepting a role in “promoting and maintaining financial stability.” It would be hard to find any that explicitly deny having such a role. But there are plenty of central banks that do not have institutional responsibilities for bank regulation and supervision, e.g. the Bank of England and the European Central Bank. But the G30 suggests that they keep their hands in, at least informally.

What is more significant for Obama administration policy formulation is that the Volcker group’s clearly expressed distaste for the central bank (read: the Fed) lending to institutions that do not normally have access to the discount window. They should be able to borrow only in emergencies. No problem there. If the regulatory system works better in the future, that will be a rare occasion. But with more than a nodding reference to the current array of Fed facilities set up to support Bear Stearns, AIG, the commercial paper market, and soon to be implemented, the mortgage securities market, the report frowns. Here is the language:

Central bank liquidity support operations should be limited to forms that do not entail lending against or the outright purchase of high-risk assets, or other forms of long-term direct or indirect capital support. In principle, those forms of support are more appropriately provided by directly accountable government entities. In practice, to the extent the central bank is the only entity with the resources and authority to act quickly to provide this form of systemic support, there should be subsequent approval of an appropriate governmental entity with the consequent risk transfer to that entity.

Would Tim Geithner, having moved from the Fed to the Treasury, sign on to this proposal, which would essentially entail a prior commitment from the US Treasury to cover any losses the Fed might make on such operations? Would Larry Summers? Or President Obama? We will learn soon enough.

The section ends with an appeal for better international coordination sounding similar to that already proposed by the Basel-based Financial Stability Forum. There are worthwhile thoughts about better data collection and sharing on all sorts of matters, including excessive leverage; closing loopholes that permit regulatory arbitrage by financial institutions seeking the friendliest regulator; and gaining greater clarity of home versus host country responsibilities, especially during crises. All good ideas, but not as likely to gain traction once

the various governments come to recognize what degrees of sovereignty they have to be willing to give up in order to achieve the objectives.

Tackling standards for accounting, risk management, and other standards

If the devil is in the details, Satan's favorite playground is accounting standards. Perhaps acknowledging that reality, the G30 report dances around the key debate over mark-to-market accounting. Unlike its other, more forceful declarations, it merely concludes that fair value accounting standards should be reevaluated "with a view to developing more realistic guidelines for dealing with less-liquid instruments and distressed markets." But who decides what is realistic? Tough-minded accountants who don't like arbitrary asset-valuations? Or central bank governors who don't want their banks to come under attack in the stock and bond markets? All of the controversy, much of which still exists, over the basic purpose as well as the implementation of the TARP program boils down to "what these damn things are worth", to quote Fed Chairman Bernanke at the Economic Club of New York a year before the crisis veered out of control. Letting banks and other financial institutions off the hook by suspending marking-to-market was a solution in the past, but those were days before instant communications and an aggressive financial media make it difficult to make up figures that don't correspond to current transactions prices.

But the rest of the voluminous set of G30 recommendations about corporate governance, risk management, capital ratios, and liquidity sufficiency are sensible, constructive, and readily adopted without Congressional legislation – simply by more forceful prudential regulators unafraid to step on high-paid toes. Getting members of boards of directors to pay attention to risk managers and seek outside verification of the credibility of internal risk management procedures would make a good start.

Upgrading financial market plumbing

A lot of damage, some permanent, has been done to the capital markets because of the reckless behavior of loan originators, complicit investment bankers, conflicted ratings agencies, and insufficiently attentive buyers. The common denominator is that the fundamental structures of the securities that were originated and sold to an all too gullible marketplace were misunderstood and thus the associated risks could never be properly evaluated. The G30 report ends with a number of helpful recommendations for restoring confidence in the securitization process. The markets for securitized assets need much closer supervision, a role that in the US has been left to the SEC. Disclosure standards for structured products need to be enhanced. The framework for using and overseeing ratings agencies needs thoroughgoing

upgrading. Almost no one disagrees. Pricing information should be more available, and so should data on trading volumes.

As for credit default swaps, the incoming Treasury Secretary may have written the recommendations himself, since they seem to have come out of several of his speeches – or ones that he has studied carefully. Much-needed planned improvements to the infrastructure supporting the OTC derivatives markets should be further supported by legislation to establish a formal system of regulation and oversight of such markets. And these should be promoted at the international level to achieve a "consistent" regulatory framework. Good advice.

A final thought

The last set of G30 recommendations are meant to cure a defect in the US system that was a genuine impediment to the successful resolution of at least one difficult case last year – Lehman. If the US had a resolution mechanism for non-bank financial institutions similar to the one that has traditionally been applied by the Federal Deposit Insurance Corporation, FDIC, Lehman could have been handled much like IndyMac. That might have been able to spare the investors of the world the biggest crash in stock market prices since 1937. By now, the recommendation is largely moot, since investment banks are becoming bank holding companies. But the negative effects of a multi-trillion USD loss of wealth linger, making the recession longer and far nastier than otherwise might have been the case.

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