WASHINGTON DC

Reform … again

Stuart Stein

Since the global financial crisis began in 2007, Washington DC has remained focused on financial reform. This is an exercise that has occurred previously following financial crises and economic stress, including establishment of the federal deposit insurance scheme in the 1930s, bank holding company reform in the 1950s, interest rate deregulation in the early 1980s, and regulatory reform following the savings and loan crisis of the late 1980s.

However, the current reform effort is different from previous measures in two crucial respects. First is the broad scope and coverage of financial reform, in that it is not targeted solely at Federal Deposit Insurance Corporation (FDIC)-insured institutions and their affiliates, but rather at all companies that impact the financial segment of the US economy. Second, financial reform is being undertaken in concert with the major economic centres in the US, the UK and Europe.

Systematic risk

Perhaps the most sweeping reform to emerge is a statutory mechanism to address systemic economic risk posed by non-banks. There has been recognition for some time that the failure of non-FDIC-insured institutions could have a devastating impact on either the US or even global economies. The co-ordinated rescue effort of the hedge fund, Long-term Capital Management, in the late 1990s was a clear demonstration that non-bank entities need a resolution mechanism.

The valuation and liquidity crises in 2008 – which saw major rescues and failures including Bear Stearns, Lehman Brothers and AIG – convinced many people of the need for federal financial regulators to be able to resolve entities that pose a systemic risk to the national or global economy. In essence, there was no regulation or oversight of those entities and the amount of risks on their balance sheets. The same can be said for major investment banks and other insurance companies that did not fail.

While financial reform in the US will include a government mechanism to identify ‘systemically important’ non-bank financial companies and activities, a major challenge for the government will be determining how to recognise systemically important entities and activities before unreasonable risks are assumed.

Too big to fail

In addition to the systemic risk of non-bank entities, the US has lived for decades with a number of FDIC-insured institutions that are simply ‘too big to fail’. These institutions, while subject to close scrutiny and oversight by federal banking regulators, have grown so massive in size and breadth, and have become so intertwined into the everyday operation of the economy, that an unwind or failure is thought by many to be untenable.

The current legislative reform aims to end the concept of too big to fail. Potentially this could have many effects, including imposing a more stringent market check on large banks. Currently, there is a measure of safety or comfort in doing business with the largest banks knowing that the government would not permit complete failure or liquidation. However, once that protection is gone, large banks previously thought of as being too big to fail will be subject to the same scrutiny by market participants as other financial institutions.

The legislation coming out of Washington also reacts to a number of other critical weaknesses in the financial system. A key feature of the legislation is the creation of a consumer financial protection agency. Oversight of consumer-oriented financial products during the past several decades has been somewhat distracted by battles regarding federal pre-emption and the authority of different federal and state governmental entities to enforce consumer protection laws. The new consumer agency is designed to establish specific avenues of regulation and responsibility.

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Similarly, as the capital market world has become infinitely more complex with the number of synthetic and derivative products, the derivative market will be subject to new oversight and restrictions.

Greatest lessons

The legislation will go beyond customary insured institution regulatory reform in other ways, including addressing matters related to securities clearance and broker dealer regulation, hedge fund registration and insurance regulation. And the bill addresses significant changes in corporate governance and executive compensation. Credit rating agency reform is also dealt with in the legislation with reform requiring structural changes in the operations of credit rating agencies designed to impose greater market discipline.

Perhaps the greatest lesson of 2008 – a reminder of which came in 2010, beginning with the concern over Greece’s debt – was that even the largest individual national economies are all closely and inexorably linked on a global basis. Therefore, while UK and EU reforms will not necessarily mirror what is coming out of Washington, the primary goals and directions of reform are generally the same.

The impact of this co-ordination will likely not be known until the next crisis.

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