

# COMPARING FINANCIAL REFORM MEASURES: HOW DOES THE SENATE BILL STACK UP?

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## Introduction

In the aftermath of the financial disaster of the last two years, there have been major attempts to overhaul the regulatory apparatus that governs the financial system. Over the last three years, there have been at least three different proposals that have been put forward in this regard: the Obama administration's white paper on financial reform put out in June 2009,<sup>1</sup> the House Bill HR 4173 (commonly called the Frank Bill) passed in December 2009, and most recently, earlier this month, Senator Christopher Dodd's vision of financial reform legislation.<sup>2</sup>

Each of these bills has its pros and cons in terms of the stated goal of restoring healthy and functional financial markets. Much of the debate has focused on a few key areas in which reform is urgent. These include the creation of a credible resolution authority, the establishment of a consumer financial protection agency, establishing meaningful limits on derivatives transactions and providing the tools to effectively manage the shadow banking system.<sup>3</sup> This brief will examine the Senate bill in terms of these four agenda items. To prefigure the discussion somewhat, though wide ranging, the bill contains some serious pitfalls that will derail the reform process unless remedied. These need to be corrected before passing—they include, but are not limited to the following points.

1. An urgent need to pursue amendments that limit the size of banks.
2. Rewriting the bill so as to seriously limit the potential for end user exemptions for derivatives.
3. Establishing genuine independence for a Consumer Financial Protection Agency
4. Pursuing detailed punitive measures for false or misleading accounting
5. Enhancing detection capability for the regulator.

## Credible Resolution

If there has been one overarching theme which has created anger and resentment in society, it has been the way in which the rescue of the financial system was carried out. Financial institutions which

<sup>1</sup> "Financial Regulatory Reform: A New Foundation," available at [financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://financialstability.gov/docs/regs/FinalReport_web.pdf).

<sup>2</sup> Text available at [http://banking.senate.gov/public/\\_files/ChairmansMark31510AYO10306\\_xm\\_FinancialReformLegislationBill.pdf](http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xm_FinancialReformLegislationBill.pdf).

<sup>3</sup> There are several other issues including the role and governance of the Federal Reserve, executive compensation, the role of credit rating agencies and the Volcker rule which are not dealt with in this brief but are examined in other pieces [on the SAFER website](#).

were for all practical purposes insolvent were kept afloat for both legal reasons (officials insisted that they did not have the legal powers to undertake the requisite action to resolve the institutions in question) and practical reasons (officials were afraid that resolution of systemically significant institutions would lead to further dislocations in financial markets and a worsening of the credit squeeze). Financial institutions were, rightly or wrongly, considered too-big-to-fail and the authorities took the road of forbearance and repeated capitalization to keep these firms alive. Forbearance of this sort is paid for by other members of society and can be hugely costly.<sup>4</sup> Given this history and the resentment it has caused, the three proposals all have ideas for the liquidation of systemically important (or as Bill Black and others have suggested systemically dangerous) institutions.

The Senate Bill has some very important and sensible provisions in the realm of resolution. First, it establishes a council (the Financial Stability Oversight Council) to assess systemic risk on an ongoing basis. Second, it calibrates capital and liquidity standards to be higher when financial services companies are considered systemically dangerous. It limits interconnectedness directly by issuing counterparty lending limits and restricting derivative and repo transactions with affiliates. It establishes a hierarchy of losses from resolution in which unsecured creditors are the first to bear losses and taxpayers are the first to receive any gains following restructuring.<sup>5</sup> It proposes a mandatory removal of management in the event of resolution. The speed with which the Federal Deposit Insurance Corporation can liquidate a failing firm is enhanced by allowing for a quick review by a panel of bankruptcy judges. In addition, it establishes a \$50 billion fund-financed by assessments on the larger financial entities-in order financing the liquidation process.

While these are certainly positive efforts they are inadequate to achieve a regime of credible resolution.<sup>6</sup> An effective resolution regime must not only manage 'the clean up' but also implement strong detection and deterrent capabilities so that a liquidation process does not have to be entered into with regularity and that remediation is possible. The Senate bill is weaker than desirable on both of these counts.

First, there is very little in the bill that provides real time detection of problems. This would require authorities to have knowledge not only of off-balance sheet activity but also of derivative exposure and the international exposure of contracts. It is not credible for the authorities in the midst of a crisis to be prompt and effective when there is a lack of clarity about possible dangers of follow on effects from the balance sheets of other firms. While the language in the bill suggests that interconnectedness will be limited, the regulator needs to have access to a full map of exposures so as to be sure of the potential consequences of their actions. Adequate reporting of such exposures is critical and is largely missing in the bill and certainly less prominent than in the House bill. This lack of information reduces the speed of prompt corrective action.

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<sup>4</sup> For an example of these costs, see Arjun Jayadev & Robert A. Johnson: *The High Costs of the Banker Bail-out: What should be done?*

<sup>5</sup> One weakness however is that it maintains that qualified financial contracts retain their hierarchical position in the resolution process.

<sup>6</sup> For a more detailed analysis of the pre requisites for full and effective resolution see "Credible Resolution: What it Takes to End Too Big To Fail?" by Robert Johnson, from the Roosevelt Institute's Make Markets Be Markets.

In terms of deterrence the Senate bill is weaker than it should be. While unsecured creditors will bear losses and management will be removed under its provisions, other important provisions are missing. For example, the bill should include provisions such as those in the House bill that establish a mandatory and substantial haircut for qualified financial contracts, to the order of 10-20%. This would further limit the undertaking of socially unproductive and risky transactions.

There are other, equally important issues with the bill with respect to resolution authority as it now stands which are problematic. The \$ 50 billion clean up fund is totally inadequate to the task at hand.<sup>7</sup> In the course of the failing of an FDIC regulated bank, clean up costs to the agency runs at an average of 23% of assets.<sup>8</sup> If the same number is applied to a large systemically dangerous institution with assets of 2 trillion (the case of, for example, JP Morgan), the requisite funds would be \$460 billion. Note further that these larger institutions are more complex and therefore may be even harder and more costly to resolve. In such a scenario the \$50 billion is best viewed as a deductible rather than a fund designed to handle the entire liquidation process. A better solution would be to make the fund proportional to the asset base of covered firms.

The bill is also way too weak in dealing with the problem of “Too Big to Fail” banks. The Senate bill attempts to limit too big to fail primarily by limiting exposure and liquidity problems. While these are positive steps, the bill does little to address the issue of existing TBTF banks. There have been many useful proposals to deal with this issue that are not in the bill. First, there have been proposals to directly limit the size of banks through expanding anti-trust provisions and implementing size caps. Thus, no financial service company could become larger than a certain amount that could be specified by a combination of profit, assets or market value.<sup>9</sup> This was debated in the House Bill with respect to the Kanjorksi amendment,<sup>10</sup> and a Brown amendment being debated in the Senate bill is an equivalently important piece of legislation.<sup>11</sup> It is becoming increasingly clear that improvements in resolution authority will fail unless serious size caps are implemented. These will be critical in limiting “too big to fail” and “too big to resolve.”

Another useful suggestion, absent from the Senate Bill is the implementation of financial transactions taxes that can have the effects of discouraging excessive financial activity on the part of large financial institutions while also raising revenue that can be used to pay for any unforeseen resolution costs.

### Consumer Financial Protection Agency

One of the key platforms of regulatory effort has been the creation of a consumer financial protection agency. As Elizabeth Warren has argued there is a critical need for a single effective agency that will make sure that new financial products themselves don't become the source of trouble for systemic

<sup>7</sup> The \$150 billion proposed in the House bill is better, but still potentially inadequate

<sup>8</sup> See Michael Konczal's "Some Arguments on Resolution Authority."

<sup>9</sup> For an extended discussion of this, see Zephyr Teachout's "Trustbusting 2.0?"

<sup>10</sup> An early version of the amendment suggested size caps, but the actual amendment as implemented in the House bill does not specify such a requirement.

<sup>11</sup> The Brown amendment will limit a bank to hold less than 3% of GDP as non-deposit liabilities. The language is available at: <http://baselinescenario.files.wordpress.com/2010/03/brown-amendment-on-liabilities-cap-march-24-20102.pdf>.

stability.<sup>12</sup> Such an agency should be independent, and consolidate the functions of the ten different agencies which all oversee various aspects of consumer financial protection. In addition, the agency's function should act as a default floor on protection and not be diluted by, or restrict attempts at stronger levels of protection by state regulators

The Senate bill is the weakest of the existing bills in terms of its treatment of consumer financial protection. Most problematically, it places the CFPA in the Federal Reserve where it will have both implicit and explicit oversight. The FSOC has the power to veto the recommendations of the CFPA with a 2/3rds majority. With respect to derivatives reform, the requisite number is a plurality. Both of these strictures seriously reduce the independence and viability of the CFPA. Equally importantly the current composition of the FSOC is heavily weighted towards the banking. As Raj Date has shown,<sup>13</sup> the FSOC board members would have permitted the growth of prime interest only and Option ARMs during the last housing bubble-hardly a ringing endorsement on their concern for consumer safety! The House Bill, while superior in its maintenance of independence for the CFPA has some loopholes, especially in terms of auto lending. There is simply no reason for the CFPA to be overseen by the board, and efforts should be made to amend the bill to reflect this.

### Derivatives Reform

Derivative reform has been a central element to every reform proposal thus far. The reasons are obvious: the use of derivatives has grown exponentially since the deregulatory drive in the late 1990s. They were central to creating the tremendous difficulties experienced in financial markets during the crisis since they were opaque, hard to value and made effective counter party risk management impossible. They are key to limiting the systemic significance of the too big to fail firms which hold the largest amount of such contracts.

The Senate Bill's language (as it now stands) is strong in this regard. It insists, as with the administration's white paper, that all standardized OTC derivatives be subject to clearing and exchange trading.<sup>14</sup> Such a policy would be welcome as it would bring in much needed price transparency to the system. In addition it provides a reporting requirement termed a "swap repository" for OTC derivatives that are not on exchange. This will provide a database of information for any derivative contract that is not regularly priced by an exchange or a clearinghouse. The onus is on users to explain when and why exchanges and clearinghouses will not accept the contract for trade. Another useful provision is that there are capital or margin requirements for swap dealers to be set by agencies. Finally, another positive is that no naked swap agreements will be permitted, thereby reducing undue pressure on firms undergoing a speculative attack if there is no material interest for the party obtaining the contract.

The bill compares favorably in comparison with both the administration's bill-especially after the exemption in the former for foreign exchange swaps - and the House bill, which added even more ex-

<sup>12</sup> For a detailed discussion on consumer financial protection see "The Broken Consumer Credit Market" by Elizabeth Warren and "A Financial Precautionary Principle: New Rules for Financial Product Safety" by Gerald Epstein and James Crotty.

<sup>13</sup> Raj Date, "Losing the Last War: Evaluating Veto Powers on Consumer Financial Protection," Cambridge Winter Center, March 21 2010.

<sup>14</sup> In addition, there should be a provision limiting dealer ownership of exchanges, for obvious reasons.

emptions. Still, there are serious loopholes in the Senate bill that should be closed. The Senate bill suggests exemption by discretion in many places, and in particular, there is an amendment in the manager's markup which gives the FSOC power to exempt derivatives from these regulations with a simple majority by specifying end user exemptions. Giving the FSOC this discretion should be resisted as far as possible, especially given the composition of the FSOC. At the very least, any decisions should be preceded by a detailed public posting of any proposed exemption with a period of time available for public comment.

### **Managing the Shadow Banking System**

The financial crisis saw a peculiar sort of bank run centered on the repo market. Jane D'Arista has called this a run on the banking system by the banking system in which investment banks that were obtaining wholesale funding from the money markets were faced with a sudden reversal in their source of funds. Given that much of credit intermediation has occurred in the last few years through this channel, there is a critical need for creating a meaningful set of regulations so that these shadow banks are limited in their ability to damage the credit markets. Several elements of reform are needed for this purpose. First, shadow banks and off-balance sheet entities should be limited in the amount of leverage and risk they can hold. Second, they should be subject to equivalent stress tests. Finally, conflicts of interest, such as arise from the expansion of proprietary trading should be eliminated (as for example proposed by the Volcker rule).

The Senate Bill attempts to limit the complexity and size of the shadow banking system. It provides regulations to increase liquidity provision so that firms do not face the degree of maturity mismatch that created so many problems in the run up to the current crisis. These will be implemented by the Fed as recommendations from Basel III are adopted. The bill further provides some reform of credit ratings agencies which had contributed to the crisis by improperly evaluating securitized products. It also provides a commission for studying the effects of implementing the Volcker rule.

While these are positive moves there are some serious omissions as well. First, there is little to no discussion on the reform of off-balance-sheet activities. Second, as a general problem, none of the bills has a well worked out set of guidelines to address the possibility of another bank run of the same sort that occurred in 2007 - 2008.

Indeed, given the importance of the shadow banking system in terms of credit intermediation, fostering procyclicality of the system, and given the high degree of concentration in the market, it is likely that the shadow system will be the fault line for any future bank run. In this event, what will be the appropriate response? Will money market funds be allowed to break the buck? Will the Fed and Treasury once again be called to backstop the system, and at what terms? At the moment, reform legislation is avoiding the question entirely, or leaving it implicitly up to the discretion of the FSOC or other bodies-with little or no examination of the pros and cons of alternative arrangements.

### **Conclusion**

The Senate Bill is a step forward in financial reform. It is nevertheless seriously lacking in several key areas. The list below is a set of simple recommendations to strengthen it.

1. More serious consideration should be given to the Brown amendment. It should be supported and size caps should be pushed. This may be the only way to handle TBTF and to make resolution credible. At the moment, the very size of the TBTF banks makes it impossible to reasonably allow them to fail.
2. There should be a greater requirement to make the road map of inter-institutional exposures clear to the regulator. This would involve more detailed information about international exposures and harmonization of rules internationally for resolution authority.
3. The Financial Stability Oversight Council should have only limited or, better yet, no power to override the Consumer Financial Protection Agency. The onus should be on the FSOC to explain any veto and there should be procedures for appeal.
4. The CFPA should be truly independent and have jurisdiction over all products, even those exempted by the House bill).
5. The FSOC should be required to have a much larger voting margin to exempt derivatives from the requirements of being standardized and exchange traded.
6. The decisions of the FSOC should be rule based, minimizing the potential for regulatory capture. Any decisions made by discretion should be comprehensively and compulsorily reported.
7. A comprehensive set of studies of remedial measures in the event of another money market induced bank run should be commissioned and clear policy decisions should be made following this.
8. The Volcker rule should be implemented soon (ideally immediately). A 16 month window is too long for the study and will allow for undue lobbying to prevent it.
9. Detailed language on accounting standards, including penalties for fraudulent accounting and limits on off-balance sheet accounting should be put in.
10. Maximum leverage limits should be re-implemented.