Financial Regulatory Reform

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Financial Regulatory Reform

- Brief review of significant regulatory gaps and shortcomings
  - What went wrong and outline goals for reform
- Overview of the Treasury Reform Proposal
  - Highlight the main goals and dimensions of reform
- Discussion of regulatory reforms under way internationally
  - Overview of proposal on capital, liquidity and compensation

What went wrong?: regulatory gaps & shortcomings

- Inconsistent and (for some) inadequate consolidated supervision and regulation of major financial intermediaries
- Arbitrage incentives in regulatory capital treatment of securitization and remote structures (e.g., SIVs)
- Lack of a “macroprudential” perspective
  - Collective failure to recognize and act on the implications of developments in housing and housing finance
- Insufficient capital and liquidity for risk

Objectives of Reform

- Enhance resilience of individual financial firms and of the system
  - The macroprudential perspective as well as the microprudential
- Better align incentives in regulatory capital and other areas of regulation and financial industry practice
- Promote consistency across firms, across markets, across activities
  - Economic risk gets like-for-like treatment

Treasury Reform Proposal

- Treasury released a financial regulatory reform proposal in June 2009
- Elements of this reform proposal are being debated in Congress, with many hearings and proposed legislation
- Many other reform proposals (academics, industry, policy groups), but Treasury proposal is indicative of the key themes
- The goals of enhanced resilience of firms and of the financial system, alignment of incentives, and consistency weave throughout

Elements of the UST Proposal: Individual Firms

- Consolidation of supervision/regulation of federally chartered banks and foreign bank branches into a single national supervisory authority
- Enhanced capital, liquidity and management standards for all banks and bank holding companies
- Fed would conduct consolidated supervision of "Tier 1 Financial Holding Companies (FHCs)"
  - Tier 1 FHC status determined by risk – if size, leverage and interconnectedness pose a threat to financial stability if the firm failed – not by charter type
  - Tier 1 FHCs would be subject to heightened supervision and regulatory standards

Elements of the UST Proposal: Systemwide

- Establish "Financial Services Oversight Council" (FSOC)
  - FSOC would include representatives from all federal financial regulatory agencies
  - Share information, identify emerging risks, settle jurisdictional disputes
  - Authority to gather information and reports from any U.S. financial firm if relevant for financial stability purposes
  - Recommendations to Fed on firms that should be Tier 1 FHCs
  - Fed must consult with the FSOC in identifying Tier 1 FHCs, systemically important payments systems, and in standards and regulations set for these entities
- Establishment of new consumer financial protection agency
  - Single agency for rule writing and supervision

Elements of the UST Proposal: Markets

- Expanded authority over systemically important payment and settlement systems for the Federal Reserve
  - Authority to strengthen settlement resources and liquidity
  - Provide access to Federal Reserve liquidity and services
- Enhance regulation of OTC derivatives markets and encourage standardization and movement onto central counterparties
- Strengthen supervision of securitization markets
  - Originators must hold material economic interest
  - Increase transparency

Elements of the UST Proposal: Crisis Management

- Enhanced resolution authority for failing non-bank financial companies (including holding companies)
  - Similar to resolution regime currently in place for banks
  - Treasury determines when to invoke this authority, with approval of Fed, FDIC, and the President
- Fed must get written permission from the Secretary of the Treasury to do 13(3) lending to non-banks

International Regulatory Reform

- Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) are seeking to enhance the global regulatory and supervisory framework
- The BCBS is working to implement a set of recommended responses (broadly) endorsed by the G20
  - The Committee's efforts include a combination of measures to strengthen resilience to economic and financial stress
  - Key proposals on capital and liquidity regulation published for consultation at the end of 2009 - development of certain initiatives, calibration and implementation will occur in 2010 and beyond
- The FSB is seeking to promote international financial stability through enhanced information exchange and cooperation in financial supervision and surveillance
  - Key initiatives include compensation standards, crisis management and consistent implementation of international standards

International Regulatory Reform: Capital

- Improve the level and quality of capital
  - Better coverage of banks' risk exposures, including for many forms of traded securities, securitization, and OTC derivatives
  - Strengthened quality, consistency and transparency of regulatory capital
  - Introduction of international leverage ratio to supplement Basel II risk-based capital requirements
- Dampen the sources of procyclicality in the financial system - practices and structures that tend to amplify rather than dampen the cycles characteristic of financial markets
  - Countercyclical capital buffers and provisions that can be built up in good times and drawn down in stress
  - Required capital conservation
  - Capital surcharge for systemically important institutions
  - Contingent capital that converts from debt to equity in times of stress

International Regulatory Reform: Liquidity

- Strengthen international framework of liquidity risk regulation and supervision
  - Basel Committee issued the *Principles on Sound Liquidity Risk Management and Supervision in September 2008* – outlined consistent supervisory expectations for liquidity risk management
- Proposed international minimum standards seek to address two complementary supervisory objectives
  - Liquidity Coverage Ratio - designed to enhance short-term resiliency by requiring institutions to hold minimum liquid assets sized to survive acute stress scenario
  - Structural Funding Requirement – designed to effect longer-term structural changes in liquidity mismatches by requiring firms to finance less liquid and longer term assets and activities with “core” or stable funding

International Regulatory Reform: Compensation

- Financial Stability Board agreed upon principals and implementation standards for compensation
  - Goal is to address incentives for mangers and risk takers
- The FSB standards established expectations for the governance and design of incentive compensation
  - Corporate governance including the role of the board of directors
  - Risk-adjusted compensation awards
  - Structure of incentive comp aligned with timing of risk and returns
  - Public disclosure
- The Fed issued supervisory guidance consistent with these standards and is conducting a horizontal review of compensation practices

International Regulatory Reform: Coordination

- Enhanced role of Financial Stability Board
  - FSB is a combination of international standard-setting bodies and a range of national authorities responsible for financial stability
  - Expanded the mandate - identify priorities, agree upon high-level principles and coordinate responses of standard setting bodies
- Expansion of FSB and Basel Committee to include all G20 countries
  - Membership expanded to add the emerging market countries

Next Steps and Key Questions

- Legislation on regulatory reform expected in the US
  - Potential to significantly change the scope and structure of regulation and regulators in the US
- Basel Committee consulting with industry and assessing potential impact of capital and liquidity proposals
  - Commitment to finalize structure and calibration of proposals by year end 2010
- Key questions:
  - How stringent should regulatory requirements and supervisory standards be? To what extent should banks and other important financial firms be expected to "self-insure"?
  - To what extent do the proposed reforms address the underlying problems that led to the financial crisis?
  - Will the proposed reforms effectively reduce the likelihood and potential severity of the next crisis?

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