“The Global Financial Crisis: A Plan for Regulatory Reform”

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OVERVIEW

This Report offers a comprehensive and detailed plan for regulatory reform in light of the global financial crisis. Some attribute the present crisis to a dearth of regulation. But that is simplistic at best, entirely inaccurate at worst. The truth is that the financial crisis is the result of—not so much a lack of regulation as—the lack of *effective* regulation. Indeed, those portions of the financial system hit the hardest by the crisis—such as traditional banks and thrifts—have historically been the most heavily regulated. We think that while more regulation is certainly needed in some areas, our overriding goal must be to make the present regulatory regime far more effective than it has been. That means that reforms should be based on solid principles—chief among them being the reduction of systemic risk. A second theme of this Report is the need for investor protection through greater transparency in the financial system. More information enables the market to more accurately price assets, risk, and other relevant inputs. Much of the present crisis can be attributed to a lack of critical information (and perhaps, in some cases, misinformation). The necessity of building a U.S. financial regulatory structure able to achieve these goals is a third theme of this Report. Simply put, our regulatory structure must be entirely reorganized in order to become more integrated and efficient. A final theme is that a global crisis demands a global solution. The U.S. financial system is best viewed as an integral part of the overall global financial system. No longer can the United States regulate in a vacuum. Coordination with other national regulators and cooperation with regional and international authorities is required.

Principles-Based Regulation Focused on Effectiveness

We believe as much attention should be paid to regulatory effectiveness as to regulatory coverage. Equally vital, we think meaningful reform must be based on fundamental principles rather than political expediency. The most important of these principles—particularly in light of the present crisis—is that regulation must reduce systemic risk. When a systemically important institution is in danger of failure, and its failure could trigger a chain reaction of other failures—the so-called interconnectedness problem—there may be no alternative other than to inject some public money into the institution. But the requisite amount of these injections has been significantly increased by several weaknesses in the current regulatory system. The Federal Reserve (Fed) financed the acquisition of Bear Stearns through a $29 billion loan, and the Fed and the Treasury have financed the survival of AIG with assistance amounting to more than $180 billion, largely because of the fear of what would have happened if such institutions had gone into bankruptcy. Similar fears may lie behind some of the TARP injections. The Committee believes there is ample room for improvement in the containment of systemic risk.

Revision of Capital Requirements

Capital regulation performed poorly during the crisis. The failure of capital regulation was not just a product of the "100 year flood" or of events that could not be anticipated. Rather, it was a direct result of both the design and substance of the regulatory capital framework. The elaborate and detailed structure currently in place to regulate bank capital, the international Basel Accord, proved unable to live up to its basic job of preventing large and systemically important financial institutions from failing. Indeed, the crude leverage ratio—that was the object of scorn of many regulators—turned out to be a more reliable constraint on excessive risk taking than the complex Basel rules, and arguably saved us from worse problems in the banking sector than those we already have. The investment banking sector, which did not have a leverage ratio, was not as fortunate. The disparity demonstrates that more detailed regulation does not necessarily make for more effective regulation. Capital requirements are our principal bulwark against bank failure, a key trigger of systemic risk. Better conceived regulation, combined with more intense prudential supervision and market discipline, is the answer. Our Report accordingly sets out a series of specific recommendations to improve bank capital regulation.

Resolution Procedures

Second, we need a better process than bankruptcy for resolving the insolvency of financial institutions. In short, our framework for banks needs to be extended to other financial institutions and their holding companies. This process, unlike bankruptcy, puts the resolution of institutions in the hands of regulators rather than bankruptcy judges, and permits more flexible approaches to keeping systemically important institutions afloat. It also ensures a more sensible approach to handling the treatment of counterparty exposures to derivatives through the use of safe harbors. At the same time, it permits, like bankruptcy, the restructuring of an insolvent institution through the elimination of equity and the restructuring of debt, to prepare the institution for sale to new investors.

Regulation of Non-Bank Financial Institutions

Third, we must recognize that the current substantive framework also suffers from important gaps in the scope and coverage of regulation—gaps that can increase the risk of shocks to the financial system. Hedge funds and private equity firms have not been supervised or regulated. Government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac were too lightly regulated; until the Housing and Economic Recovery Act of 2008, they were not subject to either meaningful capital or securities regulation. Investment bank regulation by the SEC proved entirely ineffective—major investment banks have failed, been acquired, or become bank holding companies. We need a comprehensive approach to regulating risk in the financial sector, if we are to avoid similar threats to the financial system in the future. Casting a broader net does not mean that different activities should be regulated in the same way, but it does mean that the same activities conducted by different institutions should be regulated in the same way.

Our Report focuses specifically on regulatory coverage with respect to hedge funds and private equity. In general, we believe hedge funds (and banks that engage in hedge fund activity) should keep regulators informed on an ongoing basis of their activities and leverage. Private equity, however, poses no more risk to the financial system than do other investors. But these firms, if large enough, should be subject to some regulatory oversight and periodically share information with regulators to confirm they are engaged only in the private equity business. Indeed, private equity is a part of the solution to the problem of inadequate private capital in the banking system. We recommend that ill-conceived restrictions on the ability of private equity firms to acquire banks should be removed, not just relaxed. This is an instance where regulation is preventing a solution, not offering one.

In addition to hedge funds and private equity, our Report also addresses the need to improve the regulation of money market mutual funds (MMMFs), which comprise approximately $3.8 trillion of the more than $9 trillion mutual fund industry. The MMMF plays an important role in our financial system, serving as both an investment vehicle and a cash management device. Triggered by the "breaking of the buck" of the Reserve Primary Fund, which was largely attributable to the impact of the Lehman bankruptcy on MMMF holdings of that company's commercial paper, a run ensued on MMMFs. This run had to be halted by the Fed's injection of liquidity into the funds, e.g., by financing the purchase of MMMF sales of asset-backed commercial paper to fund redemptions, and federal guarantees of existing investments. We endorse further restrictions on the type of investments such funds can make and the adoption of new procedures for halting redemptions and providing an orderly liquidation in the event of runs in the future. If federal guarantees to certain shareholder accounts are likely to persist, either explicitly or implicitly, a method needs to be devised for the government to charge for such guarantees or for the MMMFs to protect themselves against such losses.

Clearinghouses and Exchanges for Derivatives

Finally, we need to reduce the interconnectedness problem of credit default swap (CDS) contracts by the use of clearinghouses and exchanges. If clearinghouses were to clear CDS contracts and other standardized derivatives, like foreign exchange and interest rate swaps, systemic risk could be substantially reduced by more netting, centralized information on the exposures of counterparties, and the collectivization of losses. To the extent certain CDSs could be traded on exchanges, price discovery and liquidity would be enhanced. Increased liquidity would not only be valuable to traders; it would better enable clearinghouses to control their own risks through more informed margining and easier close-outs of defaulted positions.

Greater Transparency to Protect Investors

Many of the measures to reduce systemic risk advanced by this Report necessarily have the added benefit of protecting investors. However, we also believe greater transparency in various sectors of the financial system is necessary, if only to provide increased protection for investors. This Report focuses in particular on the securitization process and accounting standards.

Reform of the Securitization Process

Securitization has played an important and constructive role in the evolution of our financial system. It has brought new sources of finance to the consumer market, not only for mortgages, but also for auto loans and credit card purchases. It has permitted banks to diversify their risks. Imagine how much more devastating the impact of the fall in home prices would have been on the banking system if all mortgages had been held by banks rather than being mostly securitized (even taking into account the exposure some banks had from investments in the securitized debt itself). There is a great need to rebuild this market from the ground up now that the financial crisis has exposed critical flaws in its operation.

Originators, whether banks or brokers, need stronger incentives to originate loans that are in conformity with what they have promised. While we support efforts to improve the alignment of economic interests between originators and investors, we think a mandatory minimum retention of risk in respect of securitized assets must address a number of important issues in order to be practical and beneficial. Among other things, a minimum risk retention requirement would increase the risk of the banking sector and be difficult to enforce given the possibility of hedging. Furthermore, such a requirement would compel the originator to bear general economic risk, e.g., risk from interest rate changes, not just the risk of non-conforming assets. We believe the incentive problem should be fixed by strengthening representations, warranties, and repurchase obligations, and also by requiring increased disclosure of originators' interests in securitized offerings. Certain high-risk practices, such as "no doc" loans, should be prohibited outright. Moreover, we believe the current disclosure regime and underwriting practices can be improved. Specifically, we would increase loan-level disclosures, and encourage regulators to study ways of improving the standardized public disclosure package.

Finally, we believe an array of reforms relating to credit rating agencies (CRAs) is vital to reinvigorating the securitized debt markets. Until the crisis, CRAs had grossly underestimated the risk of loss associated with several types of structured finance securities. In order to restore confidence in the integrity of credit ratings and improve how the global fixed-income markets function in the future, we propose developing globally consistent standards, ensuring unitary systems of enforcement, avoiding governmental interference in the rating determination process, reviewing references to credit ratings in regulatory frameworks, and increasing disclosure pertaining to ratings of structured finance and other securities.

Improvements in Accounting for Fair Value and Consolidation

Two accounting issues have risen to the fore in this crisis: the use of fair value and requirements for consolidating off-balance sheet exposures. We believe the current fair value methodology, as a whole, needs serious review by FASB and IASB on a joint basis. The problem has not been solved by FASB's April 2009 guidance (to which IASB did not subscribe). We have recommended substantial improvements in disclosures, which we believe will greatly benefit investors. The Committee believes reporting institutions should separately value Level 2 and Level 3 assets—where there is no liquid market in the assets being valued—by using market prices and fundamental credit analysis, with complete disclosure of how each of these values was determined. For market prices, this would require disclosing what market prices were relied on; for credit values it would require disclosure of all the parameters used in the credit model, including the discount rate. We also believe there should be separation of regulatory and financial reporting accounting, subject to a check on regulators not using accounting rules to avoid the recognition of clear losses, i.e., forbearance. Finally, we believe FASB is on the right track on revising its consolidation standards in Interpretation No. 46R, and endorse that approach.

Regulatory Structure

The U.S. financial regulatory framework can be summed up in four words: highly fragmented and ineffective. The fragmentation of regulators is not the product of careful design—it has evolved by layers of accretion since the Civil War. It has survived largely unchanged, despite repeated unsuccessful efforts at reform, not because it has been functional or effective but because it has served the interests of industry, regulators, and politicians—even though it has not served the interests of the overall economy or the American public. The current crisis has demonstrated that this dysfunctional system comes with a very high cost. The Committee's statement of January 14, 2009 entitled, "Recommendations for Reorganizing the U.S. Regulatory Structure," proposes a new consolidated structure, comprising the Fed, a newly created U.S. Financial Services Authority, the Treasury Department and possibly a consumer and investor protection agency. We believe this structure can substantially reduce the risk of future financial crises. We again call for regulatory structure reform in this Report.

International Coordination

The Committee believes that in all areas of reform dealt with in this Report, it is essential to have a coordinated international approach. A global financial system demands globally coordinated rules. We already have international capital rules requiring significant modification. Institutions like hedge funds and private equity operate internationally. Failures of international coordination can lead to the duplication of requirements and set the stage for regulatory arbitrage. The framework for handling failed financial institutions needs to take into account their multinational structure and clearinghouses and exchanges for derivatives need to handle internationally traded derivatives, which may be subject to different requirements in different countries. Securitized debt markets are global and thus standards for origination and disclosure, as well as the regulation of CRAs, require global coordination. Additionally, there obviously needs to be coordination and convergence between U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) as we contemplate a single standard. While the world is not yet ready for a global regulator, the time has come to ensure greater global coordination.

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