

Financial Reform Moves Forward, Challenges Remain

BY RENEE COURTOIS HALTOM

By most accounts the nation's financial regulatory framework has some catching up to do. Regulation did not effectively keep pace with the profound changes in the financial system over the last several decades and was a contributing factor to the financial crisis, Fed Chairman Ben Bernanke stated in testimony to the Senate Committee on Banking, Housing, and Urban Affairs in September 2010.

The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama in July 2010, is intended to bring regulation up to speed. At 848 pages and 16 separate titles, the Act is the heftiest reform package to greet the financial system in decades. With the legislation lawmakers attempt to address an array of potential gaps in financial regulation and policy.

A key example is the notion of systemic risk. Many regulators now argue that supervision and regulation before the crisis was much too focused on the health of single institutions (microprudential supervision) at the cost of awareness concerning the financial system as a whole (macroprudential supervision). The latter would require greater focus on the linkages between firms that lend to and borrow from each other.

The Dodd-Frank Act aims to fix this problem by creating the Financial Stability Oversight Council (FSOC). The group is responsible for identifying systemically important financial institutions, which the Fed will then be required to supervise. The FSOC is comprised of staff from each of the financial regulatory agencies, including the Fed.

The mortgage boom brought attention to occasionally unsound practices in consumer finance. The Act creates an independent Bureau of Consumer Protection housed within the Fed, charged with writing consumer financial protection laws and examining financial institutions for compliance.

The legislation addresses the so-called Volcker Rule (named after former Fed Chairman Paul Volcker), which prohibits banks from certain speculative investments unless they are being made on behalf of a customer, limiting the extent to which banks can engage in risky behavior using their own money. Credit rating agencies will be more tightly regulated and less relied upon by regulators. In the area of executive compensation, shareholders of large corporations will now have a voting say in how much executives are paid.

One of the Act's stated goals is to put a credible end to government bailouts of financial institutions that fall into trouble. Several Fed policymakers have argued that actions taken by the Fed and other agencies during the crisis, though necessary given conditions, were "distasteful" (in the words of Chairman Bernanke) and "excruciating" (according to

Richmond Fed President Jeff Lacker) because of the moral hazard problems they would almost certainly exacerbate. The concern is that institutions would now be more likely to expect assistance in a crisis, which may encourage them to take undue risks and make such crises more likely.

The Act attempts to mitigate moral hazard by curbing the government's discretion to intervene. The Act limits the Fed's ability to extend some types of emergency loans under Section 13(3) of the Federal Reserve Act, the provision heavily invoked during the financial crisis for the first time since the Great Depression. The Fed is no longer allowed to lend to specific individuals, institutions, or corporations. Instead, emergency loans from the Fed are now allowed only if made available to a broad array of firms, and require Treasury approval.

The Act also sketches out a process — known as resolution authority — by which the government will step in to dismantle large, systemically significant bank holding companies or nonbank financial firms in the event of failure. (Failing banks, on the other hand, are dealt with by the Federal Deposit Insurance Corporation.) Supporters of this provision of the Act claim that without such plans, the rapid, disorderly failure of a single large firm can harm many creditors that have extended that institution loans. Others, however, have argued that by effectively shielding creditors this process could dampen market discipline.

Implementing the Act will be a significant undertaking for all regulatory agencies. It requires the Federal Reserve alone to complete more than 50 rulemakings and guidelines, many studies and reports under a short timeframe, and more than 250 separate projects and initiatives to implement the law.

It's not just the scale of the Act that poses a challenge. Many new tasks — such as judging the degree of systemic risk that an institution poses, or deciding when a firm is too imperiled that it must be dismantled — are difficult calls to make. Perhaps more important, firms will likely innovate in ways that allow them to work around new regulatory barriers they find excessively burdensome. Regulators will have to remain flexible and vigilant to maintain a regulatory framework appropriate for a dynamic financial system.

Charles Plosser, the president of the Philadelphia Fed, summed up the thoughts of many financial industry observers in a September speech: "Dodd-Frank is a massively complex piece of legislation, and many details remain to be worked out in the rule-writing underway to implement the act. It is also highly likely there will be many unintended consequences. It is too early to assess all of its ramifications or whether it can achieve all of the lofty goals that people assigned to it. Only time will tell." **RF**