

By Emily Barrett

# The regulatory (r)evolution

**U.S. regulators have their work cut out. The priority is to stop the current crisis from getting any worse, and then plug the gaps in the regulations to prevent the situation from happening again. A sheaf of white papers is in circulation, short on hard and fast rules but long on calls for voluntary embracement of best practices. Longer term there may need to be a streamlining of the regulatory bodies to enable the markets to move forward with confidence.**

Regulation has never been a popular subject on Wall Street. But now, smack-dab in the midst of the biggest crisis to ever hit the securities industry, and with congressional and presidential elections looming, it occupies center stage. After months of exposition, activity is stepping up in Washington, and the securities industry should be on alert. Overall, the proposals fall into two broad categories: how to stop the rot in the current crisis, and how to plug the regulatory gaps to prevent a recurrence. Lawmakers are debating proposals that are already raising hackles. The white papers have landed, from the Financial Stability Forum (FSF) and the President's Working Group among others. And this time they're promising more than just eye-strain for Wall Street and the investment community.

The first debates on the former are well underway. The American Securitization Forum (ASF) and the Securities Industry and Financial Markets Association (SIFMA) have already given their verdict on the freshly minted Foreclosure Prevention and Sound Mortgage Servicing Act, arguing that its demand that mortgage servicers strike easier terms for homeowners facing default would disadvantage institutional investors. And that would make matters worse for the housing market. While foreclosure must be avoided where possible, ASF Deputy Executive Director Tom Deutsch told the House Financial Services Committee in April, shifting the mortgage servicer's obligations from bondholders to the homeowner would deter more investors from the struggling secondary mortgage market, and likely lead to even tighter credit conditions for the borrowers themselves.

As for the longer-term view, the white papers are short on rules and big on furnishing, pledging suites of best practices "to be embraced voluntarily," in the case of the Institute for International Finance. Common themes emerge: broad calls for better risk management, disclosure and transparency, with particular emphasis on the role of ratings agencies to provide credible and comprehensible guidance. Governments around the world are throwing their weight behind the proposals, now that many are weighing up providing publicly funded rescues for homeowners. The G7 finance ministers and central bankers endorsed the FSF's report in March with a 100-day plan for implementation of its key points, urging that "firms should fully and promptly disclose their risk exposures, write-downs, and fair value estimates for complex and illiquid instruments," and that "robust risk disclosures in their upcoming mid-year reporting consistent with leading disclosure practices as set out in the FSF's report."

This report is exhaustive in its vision of the ideal disclosure parameters for collateralized debt obligations (CDOs), residential and commercial mortgage bonds, special-purpose entities and leveraged loans. The FSF wants figures for total exposure, including on- and off-balance sheet analysis; exposure before and after hedging; and exposure before and after write-downs. Further details include the creditworthiness of hedge counterparties, collateral type, average maturities, geographic distribution and the sensitivity of valuation to changes in key assumptions and inputs.

## The stuff of dreams

It's all good stuff — a dream scenario for any shareholder or fixed-income investor looking to hold a company or issuer fully to account. But financial institutions that would rather keep such cards close to their chest are doubtless taking comfort from the relative infrequency with which G7 recommendations become policy. That said, they will feel the first effects of closer scrutiny before long: the Basel Committee is hammering out amendments to the Basel II rules even before all banks have adopted them.

The Bank for International Settlements (BIS) said the Committee will revise its framework to “establish higher capital requirements for certain complex structured credit products, such as so-called ‘resecuritizations’ or CDOs of ABS, which have produced the majority of losses during the recent market turbulence.” Proposals to be spelt out later this year will focus on

the capital supports for off-balance sheet vehicles such as asset-backed commercial paper conduits.

But the changes also show regulators have twigged that liquidity and capital do not go hand-in-hand as Bear Stearns painfully demonstrated in March.

The BIS noted the double-digit growth of global banks' trading assets in recent years, and the comparable increase in the proportion of “complex, less liquid credit products... The current value-at-risk-based treatment for assessing capital for trading book risk does not capture extraordinary events that can affect many such exposures,” the BIS said. In collaboration with the International Organization of Securities Commissions (IOSCO), the Basel Committee is also exploring an event-risk charge, to cover complex structured products held in the trading book.

The need for “higher rates of capital and more owned — not borrowed — liquidity” is crucial to non-bank risk management, said Morris Goldstein, formerly of the International Monetary Fund and now a senior fellow and expert on financial crises at Washington's Peterson Institute. “You've got to run the system a little slower if you want it to be safer — otherwise we pay for it.”

He's of the popular view that some of the largest institutions on the fault-line of systemic risk have relied too heavily on liquidity and the ability to tap short-term borrowing to fund their business. Not until Bear Stearns was left high and dry was it clear how swiftly liquidity can evaporate, leaving it no real

choice over the weekend between a humiliating takeover at little more than a 10th of book value or a disastrous bankruptcy that could upend the entire financial system. For his part, Goldstein is working on a third way, and one that may appeal more to regulators than to Wall Street: an orderly closure rule for non-banks.

A workable bankruptcy option, Goldstein says, would avoid the nasty scenario of a hastily convened bailout, of the kind that drew criticism a decade ago when Long-Term Capital Management went belly-up, and outright censure with the much larger demise of Bear Stearns. If the New York Fed courted moral hazard by hitting up Wall Street for the \$3.6 billion rescue of the infamous hedge fund back in 1998, some say it consummated the affair last month with a JPMorgan deal for the brokerage worth around 10 times that amount. And in both cases, the failure of the regulatory infrastructure left the



*That's one of those financial regulators up there, isn't it?*

Reuters

central bank with little alternative in its bid to spare the financial system.

Indeed, the Bear Stearns fiasco pushed the regulatory debate into territory that's now being chartered on both sides of the Atlantic — central bank intervention.

The Federal Reserve's contortions over recent months have already left its authority over the financial sector too open to challenge, according to some former Fed insiders. Chairman Ben Bernanke's Fed has had its hand forced by the sheer velocity of events over the past nine months. It has more than halved its target interest rate, slashed the discount window fee premium over the target rate from one percentage point to just a quarter, and extended the terms of these loans. The Fed now has swapped Treasuries for illiquid high-quality mortgage collateral in a series of auctions and provided a discount window to the securities firms in its primary dealers' circle.

## Stepping over the line?

The most controversial step was sponsoring the sale of Bear Stearns to JPMorgan, taking on a \$30 billion portfolio of confiscated assets. The deal helped keep Bear, and its trillions of derivatives contracts, out of a bankruptcy procedure that could have destabilized financial markets worldwide. This threat became the Fed's rationale for lending directly to securities firms for the first time since the 1930s Depression. Some say it thus stepped beyond its mandate as lender of last resort to become preferred lender of every resort, and at comparatively attractive

rates.

Former Fed Chairman Paul Volker wasn't impressed: "The Federal Reserve has judged it necessary to take actions that extend to the very edge of its lawful and implied powers, transcending in the process certain long-embedded central banking principles and practices," he told the Economic Club of New York in April.

The Bear episode underscores the fact that, as the massive public consultation process grinds on in Washington, decisions are being made that are already setting precedents for regulators. And they are already profoundly changing the relationship between Wall Street and the Federal Reserve, the guardian of financial stability.

Treasury Secretary Henry Paulson met the Fed's unprecedented action with a barrage of new powers in his blueprint for regulatory reform. Paulson's plan aims for a quid pro quo: as their new creditor, the Fed would have special powers to monitor securities firms. Some Fed committee members have welcomed the idea in principle. Dallas Fed President Richard Fisher observed that "if we're going to lend money to someone we should know more about them." But they have withheld outright endorsement.

The central bank's new responsibilities wouldn't stop there. In the longer term, the Fed would become a market stability regulator-cum-supercop, with all institutions that pose substantial systemic risk on its radar, including mortgage lenders, insurance companies and hedge funds.

The exact powers of the surveillance Paulson proposes are unclear, but the wording of the plan implies the Fed could demand corrective action only if overall financial stability is threatened — a nebulous concept, as the events of recent months have shown, and one that exposes the central bank even more to the risk of doing too little, too late. To ease its load, the blueprint suggests the Fed surrender its more explicit supervision of the state-chartered banks and bank holding companies.

The Fed has already had its resources severely strained handling this crisis. And it's worth remembering that the seven-strong Board of Governors is effectively short three members. Susan Bies, formerly the Fed's representative in the FSF and pioneer of its efforts to modernize the Basel capital accord, resigned early last year. Mark Olson, a former director of regulatory consulting practice at Ernst and Young, hasn't been replaced since he left the central bank in 2006 for the top job at the Public Company Accounting Oversight Board. They were two of the board's top regulatory boffins. A third, Randall Kroszner, is still there although his term officially expired in January.

Senate Banking Committee Chair Chris Dodd appreciates each new governor's term is 14 years, and he anticipates a change of party, says Vincent Reinhart, a fellow at the American Enterprise Institute, and former director of the Federal Reserve Board's Division of Monetary Affairs. "But by waiting he's limiting the response of the Fed at a time of financial stress."

In any case, Reinhart says, installing the Fed as a supervisor of investment banks can't work. "It's a losing proposition.

That's the problem with Secretary Paulson's blueprint: it envisions the Fed as a regulator at 15,000 feet. How many CEOs have we lost in the last nine months because they didn't understand the risks their firms were taking? They didn't understand the write-offs a week in advance, how can you expect the Fed to do any better given they don't have the information those executives were privy to? It makes lending at a time of distress even more likely."

### A long-running drama

Paulson is no doubt mindful of his legacy after several unsuccessful attempts to establish leadership in the financial crisis. But his blueprint may not fare much better. Few would argue that the jerry-built regulatory structure needs a thorough overhaul if it is to offer the kind of sleek machinery of consumer and investor protection that should befit a world markets leader in the 21st century. But, as the heads of agencies targeted for the chop under Paulson's plan are well aware, government departments aren't simply dissolved in an election year.

Take John Reich, director of the Office of Thrift Supervision: "Expect to see news stories and renewed questions about what the future will hold," he wrote in a letter to employees on March 28. "The 20th anniversary of the OTS is next year. We can all expect — despite predictions over the years to the contrary — to be celebrating it."

Nevertheless, if it's new lines of business the securities industry needs, it clearly stands to benefit from the crux of Paulson's reform proposal — which is, after all, a recasting of a year-long study into how best to tailor U.S. regulation to prevent the loss of market share to financial services competitors overseas. The proposed merger of the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) — an idea that's by no means new — would bring oversight of the securities and futures industry under one umbrella. Market practitioners have long blamed the SEC's orthodoxy for hampering U.S. competitiveness, in part by stifling innovation with a lengthy approvals process, and compared it unfavorably with the CFTC ethos that, they argue, promotes open markets and competitiveness in commodities and futures trading.

The move would be a clash between two very distinct regulatory styles — the SEC's rules-based approach versus the CFTC's principles-based approach. Paulson's early proposals suggest the latter would have the upper hand. But politically, it could be tough to sell the idea of shedding regulators to improve supervision, and Amaranth's face-plant is a reminder of the shortcomings of a light touch.

The already noisy regulatory reform portends to be a long-running and cacophonous drama with many bit players, some cameos and few heroes. ▼

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