Lawmakers Dodge Key Issues in Reg Reform

Financial Planning
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WASHINGTON — Though touted as a way to avert the next financial crisis, the massive regulatory reform bill awaiting a Senate vote ignores key contributing factors, including an inefficient and outdated regulatory structure, a broken housing finance market and weak underwriting standards that spurred a wave of unaffordable mortgages.

"As big as the bill is and as major as some of the changes are, there are still a number of things that are left on the table," said Joseph Engelhard, a senior vice president with Capital Alpha Partners LLC.

Even on some issues the 1,300-page bill does address, it does so halfheartedly. New capital and liquidity standards — the most vital part of the reform effort according to many experts — are left to regulators to shape as they see fit.

And although American International Group was one of the biggest collapses of the financial crisis, the bill would do little to provide federal oversight of the insurance industry.

Accounting issues are another untouched area.

"What's wrong with these bills is they do not fix the regulatory system that led us into this problem," said William Isaac, a former Federal Deposit Insurance Corp. chairman and now the chairman of LECG. "They don't deal with the accounting at all. Mark-to-market accounting was a major contributor to this crisis. They don't deal with the Basel capital accords and the procyclical accounting for loan-loss reserves. … The bill doesn't come up with an independent watchdog to oversee the system."

To be sure, the bill includes many provisions that could have a positive impact. It would compel regulators to monitor the system as a whole and subject systemically significant banks and nonbanks to the same oversight.

It would provide greater tools to handle the resolution of a systemically significant firm and increase the transparency and regulation of derivatives. It would attempt to hold the credit rating agencies more accountable and set up an apparatus to increase the focus on consumer financial protections.

Still, the holes are easy to spot.

For one, the very thing that brought about the collapse — the housing finance system — is largely ignored. Fannie Mae and Freddie Mac, which critics had central roles in the crisis and whose collapse will cost the government billions, are not even discussed.

"The silence on Fannie and Freddie is deafening," said Lawrence White, an economics professor at New York University's Stern School of Business. "How can they look at themselves in the mirror every morning thinking that they have a regulatory reform bill and they are totally silent on Fannie and Freddie? It just boggles my mind."

Hal Scott, the director of the Program on International Financial Systems at Harvard Law School, agreed. "It doesn't address GSE reform, which arguably is the most costly part of the entire bailout process," he said. "If you look at the money we've actually spent on the bailout … the GSEs are costing us billions. There is no solution to that. That fact is the biggest gap in the reform."

Similarly, the bill does not directly address an undisputed cause of the crisis — poor underwriting standards that allowed lenders to make loans that borrowers simply could not afford.

While the House has tried to address that issue since 2007, the Senate bill would leave new standards for banks and nonbank mortgage lenders to a proposed consumer protection division. But by not tackling it directly, there is no way to know if that is sufficient, observers said.

"In terms of going back in time, if we had had the consumer regulatory agency in early 2007, it's possible we would not have had the toxic subprime mortgages that came out, but I think it's questionable," said Brad Sabel, a partner with Shearman & Sterling LLP and a former Fed lawyer. "Hindsight is a wonderful thing."

The bill would attempt to address lenders that sold mortgages to the secondary market without proper risk analysis by imposing a 5% risk-retention requirement unless the loan met certain standards defined by regulators.

Still, even industry representatives wondered why lawmakers are passing up a long-coveted chance to set minimum federal underwriting standards.

"If you want to ensure accountability, close the regulatory gaps that exist today where you have uneven regulation between federal- and state-chartered entities and from state to state," said Steve O'Connor, the senior vice president of government affairs for the Mortgage Bankers Association. "Let's set a robust and rigorous set of standards for the entire marketplace."

The bill also does little to address another key problem of the crisis: regulators who had the power to take action but never did so. The regulators are allowed wide latitude under the bill to set some of the most critical standards, including capital, liquidity, collateral and leverage requirements.

While many say such flexibility is necessary, others argue lawmakers should provide some specific limits. "It just leaves to regulatory discretion those issues that regulators already" had authority over, said Raj Date, the chairman and executive director of the Cambridge Winter Center for Financial Institutions Policy. "Unless we are expecting a breed of superhero regulators to emerge, it's hard to have a lot of comfort about that." Date and others said Congress is missing

a chance to put in requirements similar to prompt corrective action, which compels regulators to take action at certain points. For example, Date said lawmakers could mandate that if capital fell below a certain level, a bank could not pay dividends.

"There are lots of different levers on capital — one of them is dividends — and it's a means by which you might be able to assert some kind of discipline on bank management … without totally hemming in regulatory discretion," he said. "There are ways to create a little bit of specificity without going overboard."

Others said Congress should have pressed for a mechanism to ensure that regulators don't continue to work procyclically — allowing banks to do as they please in good times and harshly cracking down during a crisis. "I tend to think that the most important thing is to have in place … a way to institutionalize the role of countercyclical regulation," said Robert Hockett, a law professor specializing in banking regulation at Cornell University Law School. "A regulation, or somebody to tighten up the money when things get a little too loose or too frenetic or frothy and to loosen up the money when things get too constrained or constricted."

The bill would also largely leave intact a multiagency system that many say allowed problems to fall through the cracks and never made sense in the first place.

Under the legislation, the number of banking regulators would drop from four to three, with the Office of Thrift Supervision merged into the Office of the Comptroller of the Currency. It would still allow banks to shop among different charters and different regulators, looking for the least stringent one.

That's a far cry from the original plan of Senate Banking Committee Chairman Chris Dodd, whose first bill would have created a single banking regulator.

To be sure, the bill contemplates some significant changes. The Fed, for example, would lose oversight of more than 800 state member banks and any holding company with assets of less than $50 billion. But even that is likely to be changed before a final bill is enacted, observers predicted, with the Fed and state supervisors leading a charge to alter that provision.

"Dodd's earlier draft made a lot of sense putting all the regulatory authority into one agency," Sabel said. "Instead of over four agencies, it's now three. Big deal. It's still a system that grew haphazardly over two centuries and we haven't bothered to clean it up."

Although it's unclear how much charter-shopping contributed to the crisis, many observers said regulatory reform was one of the last chances to properly modernize the system. Many long-sought reforms, including merging the Securities and Exchange Commission and the Commodity Futures Trading Commission and creating a federal insurance charter with an appropriate regulator, are not included in the bill.

"The danger is that 15 to 20 years from now, things... will fall through the cracks again," Engelhard said. "If you don't have a good regulatory structure, things get missed."

Eugene Ludwig, a former comptroller who is now the chief executive of Promontory Financial Group, sees a far bigger problem. Although the Fed would gain oversight of systemically important firms, including large hedge funds and insurance giants, he said the regulatory reform bill is still mostly focused on banks, not the nonbanks that helped cause the crisis.

"The shadow system concerns me most," Ludwig said. "It's popular to bash the banks, but when you actually look at who failed and caused the taxpayers to pay oodles of money that may never be repaid, it's not the banks."

The bill, Ludwig said, "has drifted in the direction of being more bank-centric and less focused on the shadow banking system. The tendency to over-regulate the banking industry and under-regulate nonbank financial companies helped bring us to where we are today."